Source: Estate Planning/Estate Planning for Special Assets/Contents

Contents

Preface

About the Authors

Selected Developments

Cutoff Dates and CEB Citation

1 Business Entity Valuation Planning Strategies

Steven Murray Goldberg

2 Succession Planning for the Family Business

Denise M. Riley

3 Estate Planning for Vineyards, Farms, and Ranches

Harry B. Maring

4 Estate Planning for Vacation Homes

Monica Dell'Osso

5 Estate and Inheritance Tax Planning for California Residents With Out-of-State Property

Robin L. Klomparens
Betty J. Little

6 Estate Planning for Companion Animals/Pets

Elizabeth Anne Bird

7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation

Ralph E. Lerner

8 Copyrights, Patents, and Trademarks

Peter R. Afrasiabi
Timothy J. Kay

9 Estate Planning for Restricted Securities

Russell G. Allen
Don R. Weigandt

10 Estate Planning With Compensatory Stock Options

Patrick McCabe
Thomas Scholz

11 Planning for Disposition of a Law Practice

Marshal A. Oldman
Frayda L. Bruton

Table of Statutes, Regulations, and Rules

Table of Cases

Table of References

Table of Forms

Index

© The Regents of the University of California

Preface

There are many books on estate planning and on document drafting to implement those plans for the typical estate—a home, cars, bank and brokerage accounts, life insurance, annuities, and IRA accounts. But when was the last time you saw a "typical" estate? Invariably, your clients have assets—and questions about those assets—that require special consideration or present special challenges. From a vacation home or a California law practice to the fate of beloved pets, one or more of the client's assets may present unique counseling and drafting challenges. This book covers assets that present special counseling and drafting issues, *e.g.,* out-of-state property, a family business, as well as assets such as patents and copyrights or a vineyard. It discusses how to counsel your clients, gather the information you need, and draft the appropriate documents.

The book was written and reviewed by leading practitioners and specialists in estate planning, who gave generously of their time and expertise. The author's biographies appear in the "About the Authors" section that follows this preface.

The following individuals served as consultants on this book by helping us in the planning process to identify the most important issues and by reviewing and commenting on chapters within their areas of expertise. Their valuable suggestions have made the book more accurate, more practical, and more reflective of California practice. CEB is indebted to each: Richard C. Dayton, Attorney at Law, San Jose; Monica Dell'Osso, Burnham Brown, Oakland; Paul N. Frimmer, Irell & Manella LLP, Los Angeles; Roy S. Gordet, Attorney at Law, San Francisco; Olivia Hansen, Luce, Forward, Hamilton & Scripps LLP San Diego; John A. Hartog, Inc., California Trust & Estate Counsellors, LLP, Orinda; Diana Hastings Temple, Attorney at Law, San Francisco; Michael Patiky Miller, Weinberg Ziff & Miller, Palo Alto; Betty J. Orvell, Reed Smith LLP, Oakland; Ruth E. Ratzlaff, Attorney at Law, Fresno; Catherine Raye-Wong, Raye-Wong & Associates, San Carlos; and Robert D. Taisey, Holland & Knight LLP, New York, NY.

Steven Murray Goldberg, the author of chapter 1, wishes to thank Ronald P. Wargo, associate attorney in the firm of Friedemann O'Brien Goldberg & Zarian LLP, for his valuable contributions to this chapter.

Portions of chapter 5 were adapted from an article by CEB attorney Jeffrey A. Dennis-Strathmeyer: *View from the California Tax Haven: The Estate Tax Decoupling Mess*, 24 CEB Est Plan Rep 8 (Feb. 2003).

Janette Tom, CEB attorney, served as editor and project manager for Estate Planning for Special Assets. The legal editors were CEB attorneys Robert Denham, Jean Magistrale, and Frederike Schilter. Legal research was provided by Shawn Ridgell and Frederike Schilter. Richard Dempewolf was responsible for copyediting and production. Robert W. Burke prepared the index. The cover was designed by Grier Thornburg. Composition was performed by CEB's Electronic Publishing staff.

December 2009 Update

CEB gratefully acknowledges the contributions of the following attorneys, who served as authors of this update: Peter R. Afrasiabi, One LLP, Costa Mesa; Elizabeth Anne Bird, San Francisco/Wilmington, N.C.; Monica Dell'Osso, Burnham Brown, Oakland; Steven Murray Goldberg, Friedemann Goldberg LLP, Santa Rosa; Robin L. Klomparens, Wagner Kirkman Blaine Klomparens & Youmans, Mather; Ralph E. Lerner, Withers Bergman LLP, New York; Harry B. Maring, The Maring Law Firm, San Francisco; Patrick McCabe, Morrison & Foerster LLP, San Francisco; Don R. Weigandt, J.P. Morgan Chase Bank, N.A., Los Angeles.

CEB Attorney Editor Janette Tom and Legal Editors Frederike Schilter and Kate Sheppard contributed to this title. Administrative support was provided by Kenya Denman and Nila Kanzaria. Elizabeth J. Asborno handled copyediting and production. Kathryn Te Selle prepared the index. Composition was performed by CEB's Electronic Publishing staff.

Michael Fenger
Practice Group Manager
Estate Planning

Pamela J. Jester
Director

© The Regents of the University of California

About the Authors

PETER R. AFRASIABI is a partner in the intellectual property and entertainment firm of One LLP in Costa Mesa, where he specializes in copyright, trademark, patent, and entertainment litigation. Mr. Afrasiabi is also an Adjunct Professor of Law at the Chapman University School of Law and has been an expert witness in litigation in Europe regarding the U.S. copyright laws. He received his B.A. from University of California, Los Angeles, and his J.D. from the USC School of Law. He clerked for a federal appellate judge at the United States Court of Appeals for the Ninth Circuit as well as for a federal district judge at the United States District Court for the Central District of California. He is a Director and Officer of the Federal Bar Association of Orange County.

RUSSELL G. ALLEN is a sole practitioner in Newport Beach. His practice is limited to estate planning and administration and related transfer tax matters for a small group of clients. He received his B.A. in 1968 from Grinnell College and his J.D. in 1971 from Stanford Law School. A frequent lecturer, he has authored numerous publications and spoken on trusts and estates, business planning, charitable giving, fiduciary administration, and related subjects. Mr. Allen is a Fellow of the American College of Trust and Estate Counsel, and is certified as a specialist in Estate Planning, Trust, and Probate Law by the State Bar of California Board of Legal Specialization.

ELIZABETH ANNE BIRD worked for many years as an attorney specializing in trust and estate planning, estate trust and estate administration, and trust and estate litigation. She received her B.A. in 1972 from University of California, Berkeley, and her J.D. in 1978 from the University of California, Hastings College of the Law.

FRAYDA L. BRUTON is a member of California Trust and Estate Counselors LLP in Sacramento. She received her B.A. from Wayne State University. She received her J.D. in 1985 and LL.M. in 1987 from McGeorge School of Law. Ms. Bruton is a Fellow of the American College of Trust and Estate Counsel and is a board-certified specialist in Estate Planning, Trust and Probate Law. She is currently Vice Chair of the Sacramento County Bar Probate and Estate Planning Section. Ms. Bruton is a frequent author and speaker on topics ranging from trust and estate litigation to various estate planning issues, including ethics and change-in-ownership rules. She is coauthor of CEB's Post-Mortem Trust Administration Outline (1994). Ms. Bruton is a past chair of the California State Bar Trusts and Estates Section and a former member of the Executive Committee of the California State Bar Trusts and Estates Section.

MONICA DELL'OSSO is a partner in the firm of Burnham Brown in Oakland, where she heads the Trust and Estate Practice Group. She received her B.A. in 1971 from St. Mary-of-the-Woods College, her J.D. in 1981 from the University of California, Berkeley, School of Law, and a Ph.D. in history in 1989 from the University of Virginia. Ms. Dell'Osso is a Fellow of the American College of Trust and Estate Counsel, and is a past chair of the Estate Planning, Trust, and Probate Law Section of the Alameda County Bar Association. She is a member of the Advisory Board of the UCLA-CEB Estate Planning Institute and a former member of the Executive Committee of the Trusts and Estates Section of the State Bar of California. She is certified as a specialist in Estate Planning, Trust, and Probate Law by the State Bar of California Board of Legal Specialization.

STEVEN MURRAY GOLDBERG is a partner in the firm of Friedemann Goldberg LLP in their Santa Rosa office, specializing in estate planning, tax, trust, and estate administration, and business law. He received his B.A. in 1979 from California State University, San Jose, and his J.D. in 1984 from the University of California, Berkeley, School of Law. He is a member of the Taxation and Trusts and Estates Sections of the California State Bar. Mr. Goldberg is certified as a specialist in Estate Planning, Trust, and Probate Law by the State Bar of California Board of Legal Specialization.

TIMOTHY J. KAY is a partner with Snell & Wilmer LLP in Irvine, where he concentrates in tax, trust, and estate matters with an emphasis in estate planning, trust, and probate administration, and estate and gift taxation. He received his B.A. in 1975 from the University of San Francisco, and his J.D. in 1987 from Stanford Law School. Mr. Kay has coauthored chapters of CEB's California Will Drafting and J.K. Lasser's Estate Tax Techniques and is a frequent lecturer on estate planning topics. He is Second Vice President, Board of Directors of the Orange Coast Estate Planning Council. Mr. Kay also serves on the Board of Directors of Boys Republic in Chino, California as a Vice President and member of the Executive Committee, and on the Board of Directors of the Orange County Council, Boy Scouts of America.

ROBIN L. KLOMPARENS is a member of Wagner Kirkman Blaine Klomparens & Youmans in Mather. She received her B.A./B.S. in 1982 from the University of Florida, and her J.D. in 1985 and an LL.M. in taxation in 1986 from the University of Miami. Ms. Klomparens is a frequent author and speaker on various tax and advanced estate planning techniques. She is an adjunct professor to the graduate tax program of Golden Gate University. She is a member of the Executive Committee of the Tax Section of the State Bar of California and is the chair of the Estate and Gift Tax Sub-Committee. She is also a member of the Probate, Family Law, and Taxation Sections of the Sacramento County Bar Association, the Taxation Section of the American Bar Association, the Planned Giving Advisory Board of Sacramento State University, and a Board Member of the Make-A-Wish

Foundation, the M&M Whitmire Private Foundation, and the Carrera-Joffee Private Foundation.

RALPH E. LERNER is the preeminent attorney practicing full time in the field of art law. He is counsel at Withers Bergman LLP in New York and the co-author of the award-winning treatise *Art Law: The Guide For Collectors, Investors, Dealers, and Artists* (3d ed, New York, Practicing Law institute, 2005). He received his B.S. in 1964 from Bucknell University, his J.D. in 1967 from Boston University School of Law, and his LL.M. in 1969 from New York University School of Law. He has served as Chairman of the Art Law Committee of the Association of the Bar of the City of New York, Chairman of the Fine Arts Committee of the New York State Bar Association, and Chairman of the Visual Arts Division of the American Bar Association Forum on Entertainment and Sports Law. He is currently on the Board of the New York Volunteer Lawyers for the Arts and is a Fellow of the American College of Trusts and Estates Counsel. Mr. Lerner is a nationally acclaimed speaker and writer on the topic of tax planning for collectors and artists. He has extensive experience in dealing with the Internal Revenue Service in the broadest possible manner and numbers among his clients many of the foremost artists, collectors, and art dealers in America.

BETTY J. LITTLE is an associate with Weintraub Genshlea Chediak Sacramento in the Estate Planning, Tax, and Fiduciary Abuse Section specializing in tax controversy issues, including income tax, sales, and use tax, and IRS audits and appeals, as well as estate planning and estate and gift taxation. She received her B.S. in 1989 from California State University, Sacramento, and her J.D. in 2002 from McGeorge School of Law. Ms. Williams is the Chair of the Sacramento Chapter of the State Bar of California, Young Tax Lawyer Section, as well as the Speaker Chair of the Sacramento County Bar, Taxation Section. She is the Chair-Elect for the 2005 State Bar of California, Young Tax Lawyer Section, the Education Chair-Elect for the State Bar of California, Estate and Gift Tax Section, as well as the Chair-Elect of the Sacramento County Bar, Taxation Section.

HARRY B. MARING is the principal of The Maring Law Firm in San Francisco. He received his B.A. in 1976 from Vanderbilt University, his J.D. in 1979 from Cumberland School of Law of Samford University, and an LL.M. in taxation in 1980 from New York University School of Law. Mr. Maring has extensive experience in estate taxation and planning, tax litigation, and all areas of tax, corporate, and business planning for individuals and entities. He is an adjunct professor to the graduate tax law program of Golden Gate University School of Law as well as to Hastings College of the Law. Mr. Maring is certified as a specialist in Estate Planning, Trust, and Probate Law by the State Bar of California Board of Legal Specialization. He is a frequent author and speaker on various estate planning topics, including estate planning for blended families and cross-over issues in estate planning and marital dissolutions. He serves on the Board of Directors and subcommittees of several Bay Area nonprofit organizations and is a past member of the board of Big Brothers/Big Sisters of San Francisco and the San Francisco Public Library Foundation—Financial and Corporate Research.

PATRICK McCABE is a partner in Morrison & Foerster LLP's Trusts, Estates, and Non-Profit Organizations practice. He received his B.A. in 1989 from the University of Utah, and his J.D. in 1992 from Cornell University Law School. Mr McCabe represents individual clients in the areas of estate and gift taxation, estate planning, estate administration, charitable gift planning, probate, trust, and community property law. He has expertise in planning for closely held business owners, and he has experience in court proceedings dealing with the division, administration, modification, and termination of trusts. Mr McCabe also advises individual and corporate clients in matters involving stock option plans, employee benefits, nonqualified retirement plans, and planning for executive compensation. Mr. McCabe is a member of the sections on taxation, estate planning, probate, and trust law of the American, California, and San Francisco Bar Associations.

MARSHAL A. OLDMAN is a partner in the firm of Oldman, Cooley, Leighton, Gold & Birnberg, LLP in Encino. His practice focuses on probate administration and litigation and estate planning. Mr. Oldman received his B.A. in 1973 from the University of Southern California, and his J.D. in 1976 from the University of California, Los Angeles, School of Law. He is past chair of the Trust and Estate Section of the Los Angeles County Bar Association, past president of the San Fernando Valley Bar Association, and past chair of the Trusts and Estates Section of the State Bar of California.

DENISE M. RILEY, a tax associate with Orrick, Herrington, & Sutcliffe LLP in San Francisco, concentrates her practice in the areas of trusts, estate and gift tax, and generation-skipping tax planning, probate and trust administration, and transfer tax controversies. She represents families owning substantial interests in closely held and publicly traded corporations, advising on matters ranging from family partnerships, limited liability companies and S corporations to private foundations, charitable trusts, and arrangements for the transfer of wealth to succeeding generations. Ms. Riley received her B.B.A. in 1987 and her J.D. in 1990 from the University of Iowa. She received her LL.M. in 1994 from Golden Gate University. She currently is Vice Chair of the Continuing Legal Education Committee, and a member of the Estate and Gift Tax Committee, of the American Bar Association Section of Real Property, Probate and Trust Law. She is a former president of the San Francisco Area Women Tax Lawyers, and a former member of the Executive Board of the Estate and Gift Tax Committee of the State Bar of California Taxation Section. She regularly lectures on a variety of estate planning topics, including business succession planning, and other sophisticated estate planning techniques.

THOMAS SCHOLZ is an attorney in Morrison & Foerster's San Francisco office. He received his B.A. in 1994 from the University of California, Berkeley, and his J.D. in 1997 from the University of California, Los Angeles, School of Law. His practice focuses on the representation of emerging high-technology companies and established domestic and foreign companies in

the areas of executive compensation and employee stock plans. Mr. Scholz has extensive experience designing a variety of equity-based compensation arrangements, including incentive and nonqualified stock options, restricted stock, and employee stock purchase plans. Mr. Scholz also provides clients with advice regarding the accounting, taxation, and SEC compliance issues that affect compensation arrangements. He is a member of the National Association of Stock Plan Professionals.

DON R. WEIGANDT is Managing Director for Wealth Advisory with The Private Bank J.P. Morgan Chase Bank, N.A., Los Angeles. In that capacity, he focuses on maximizing after-tax wealth across multiple generations, using innovative tax and estate planning strategies. He joined J.P. Morgan after a 25-year career in private law practice in New York and Los Angeles. Mr. Weigandt writes and speaks on a variety of topics and is also regularly quoted in national publications as an expert on matters of taxation and estate planning. Mr. Weigandt graduated from Yale University in 1969 with a B.A. in economics and received his law degree from Columbia University's School of Law in 1974. He is admitted to practice in California and New York and is a member of several national, state, and local bar associations.

© The Regents of the University of California

Selected Developments

December 2009 Update

For 2010, the annual exclusion for gifts remains at $13,000. Rev Proc 2009-50, 2009-45 Int Rev Bull 652. See §§1.3, 3.11, 4.30, 10.10.

Discussion of legislative proposals that would modify or enlarge the application of IRC §2704(b) was added to §1.28.

A partnership that holds only marketable securities may have difficulty showing legitimate nontax purposes for forming a business entity. See, *e.g., Estate of Emma V. Jorgensen*, TC Memo 2009-66. See §1.37B.

In *Keller v U.S.* (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015, the court held that protecting assets from divorce was a legitimate nontax purpose and satisfied the bona fide sale exception of IRS §2036(a). See §1.37B.

In *Heckerman v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,578, 104 AFTR2d 5551, and *Linton v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,575, 104 AFTR2d 5176, the courts held that donors made indirect gifts of assets transferred to an LLC on the same day that they transferred LLC units to trusts for children. See §1.37D.

In *Suzanne J. Pierre* (2009) 133 TC No. 2, the court held that gifts of membership interests in a single-member LLC were gifts of LLC interests rather than gifts of the underlying assets of the LLC. See §1.37D.

The discussion of electing small business trusts has been expanded. See §2.36.

For decedents dying in 2009 and 2010, the maximum inflation indexed special use valuation reduction cannot exceed $1 million. Rev Proc 2008-66, 2008-45 Int Rev Bull 1107; Rev Proc 2009-50, 2009-45 Int Rev Bull 652. See §§3.19, 3.32, 3.52, 3.71-3.72.

For decedents dying in 2009, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under IRC §6601(j)) of the estate tax deferred under IRC §6166 is $1.33 million. Rev Proc 2008-66, 2008-45 Int Rev Bull 1107. For decedents dying in 2010, the dollar amount used to determine the "2-percent portion" is $1.34 million. Rev Proc 2009-50, 2009-45 Int Rev Bull 652. See §3.81.

The discussion of transferring a vacation home to an irrevocable trust has been expanded. See §4.18.

Discussion of using a conservation easement in combination with a QPRT has been added. See §4.24.

A chart that shows the additional tax burden in a decoupled state has been added. See §5.9.

In *Estate of Stevenson v Director, Div. of Taxation* (2008) 23 NJ Tax 583, the New Jersey Tax Court ruled that a tax clause that required payment of all estate taxes from the marital share of the residue of the estate resulted in a larger state estate tax by reducing the marital deduction equal to a hypothetical federal estate tax that would have been due if the decedent had died on December 31, 2001. See §5.16A.

The chart on the status of states regarding decoupling has been updated. See §5.26.

The list of animal protection organizations that provide adoption services or permanent care has been updated. See §6.9.

Chapter 8, "Copyrights, Patents, and Trademarks," has been revised. The discussion of copyright termination rights has been expanded (see §§8.15A-8.17), and discussion of trademarks has been added (see §§8.33A-8.33I).

In *Penguin Group (USA) Inc. v Steinbeck* (2d Cir 2008) 537 F3d 193, the court ruled that the termination notice filed by Steinbeck's descendants was invalid because a 1994 agreement superseded the 1938 agreement and there was no longer a pre-1978 agreement to terminate. See §8.15E.

For a case discussing penalties for selling unregistered securities in the public markets outside Rule 144's safe harbor, see *In re Dudchik* (Dec. 5, 2008, No. 3-12943) 2008 SEC Lexis 2856. See §9.5.

The 50-percent exclusion of gain recognized on the sale of qualified small business stock (see IRC §1202(a)) is increased to 75 percent for sales after February 17, 2009, and before January 1, 2011. IRC §1202(a)(3). See §9.16.

The figures in the example of tax calculations for a single taxpayer on the exercise and sale of incentive stock options were updated. See §10.44.

© The Regents of the University of California

Cutoff Dates and CEB Citation

Cutoff Dates

We completed legal editing and analysis of authorities cited in this publication as of September 8, 2009, and monitored developments through October 23, 2009.

CEB Citation

Cite this publication as: Estate Planning for Special Assets (Cal CEB 2004).

© The Regents of the University of California

1

Business Entity Valuation Planning Strategies

Steven Murray Goldberg

I. INTRODUCTION

A. Overview §1.1

B. Popularity of Limited Partnerships and Limited Liability Companies §1.2

C. Typical Planning Situations and Concerns §1.3

D. Ethical Considerations: Conflicts and Competence §1.4

II. CHOICE OF ENTITY AND FORMATION ISSUES §1.5

A. Limited Partnerships §1.6

1. Choice of General Partner §1.7

2. Requirement of Two or More Persons §1.8

B. Limited Liability Companies §1.9

C. Corporations §1.10

D. Choosing Entity

1. Corporation Versus FLP or FLLC §1.11

2. FLP Versus FLLC §1.12

E. Choosing Assets §1.13

III. ESTATE AND GIFT TAXES

A. Valuation Discounts §1.14

1. Lack of Marketability §1.15

2. Lack of Control §1.16

3. Mathematics of Discounts §1.17

4. Income Tax Consequences §1.18

B. Valuation Premiums §1.19

1. Control Premium §1.20

2. Swing Vote Premium §1.21

C. IRC Chapter 14 Valuation Rules: IRC §§2701-2704

1. Introduction §1.22

a. IRC §2701 §1.23

b. IRC §2702 §1.24

c. IRC §2703 §1.25

d. IRC §2704 §1.26

(1) IRC §2704(a) §1.27

(2) IRC §2704(b) §1.28

(3) Dissolution §1.29

2. IRS Attacks on Valuation Discounts §1.30

3. Court Responses to IRS Arguments §1.31

a. IRC §2704(b) Argument §1.32

b. Lack of Economic Substance Argument §1.33

c. IRC §2703 Argument §1.34

d. Lost Value Argument §1.35

e. Family Attribution §1.36

4. IRS Litigation Using IRC §2036(a) §1.37

a. Application of IRC §2036(a)(1) and (a)(2) §1.37A

b. Significant Nontax or Business Purpose §1.37B

c. Other Strategies to Avoid IRC §2036(a) §1.37C

d. Application of Step-Transaction Doctrine §1.37D

5. Planning Responses to IRC §2036(a) Attacks §1.37E

D. Appraisals

1. Documenting Discount §1.38

2. Contents of Appraisal §1.39

3. Adequate Disclosure Requirement for Gift Tax Return §1.40

E. Circular 230 §1.40A

IV. STRUCTURING AND FORMING FAMILY BUSINESS ENTITY §1.41

A. Business Purpose §1.42

1. Centralized Management and Control §1.43

2. Pooling of Assets §1.44

3. Investment Training §1.45

4. Family Values and Bonding §1.46

5. Family Businesses §1.47

6. Limited Liability §1.48

7. Asset Protection §1.49

B. California Law

1. Restrictions on Liquidation Rights §1.50

2. Restrictions on Transfers §1.51

3. Real Property Tax §1.52

4. Other Substantive Law Considerations §1.53

C. Family Business Entity Formation Combined With Other Estate Planning Techniques §1.54

© The Regents of the University of California

I. INTRODUCTION

§1.1 A. Overview

Family business entities are widely used in the estate plans of sophisticated clients and are an important tool for the estate planner. Family business entities may accomplish a number of goals, including (1) income, gift, and estate tax planning and tax savings through valuation discounts; (2) centralized management of assets; (3) pooling of assets; (4) asset protection; and (5) training younger generations in management of assets. The ability to meet multiple goals has contributed to the popularity of these entities. However, family business entities can be complex and expensive to implement. They are often treated by the IRS as aggressive for gift and estate tax planning and therefore are subject to heightened scrutiny.

Any time a family business entity is used, consideration must be given to tax issues, including gift, estate, generation-skipping, income, and real property taxes. The structure of the entity also affects the current and future management of the entity, how well the assets may be protected from the individual owners' creditors, and certain tax advantages. These issues make planning complex and can conflict with one another. This chapter is intended to provide a discussion of these issues and the related concerns that practitioners in this area must address when using a family business entity as an estate planning tool. Although the discussion focuses mainly on valuation issues and potential tax advantages that may arise in using these entities, it is the author's opinion that family business entities should and usually do meet other, nontax goals. Practitioners must also be aware of rapidly evolving case law and legislative proposals. Some recent developments favor the taxpayer, while others favor the IRS. As a result, careful planning is still needed to obtain estate tax valuation discounts. The author believes it is now clear that the family business entity must have significant nontax objectives.

© The Regents of the University of California

§1.2 B. Popularity of Limited Partnerships and Limited Liability Companies

The closely held corporation, limited partnership (LP), and limited liability company (LLC) are all used as estate planning vehicles. Valuation discounts for estate and gift tax purposes and limited liability for most or all of the owners apply to each of these entities. The LP and LLC have enjoyed the most popularity as family business entities, due in part to the flow-through nature of these entities for income tax purposes, and in part to the flexibility in management that they can provide. In the family context, these are commonly referred to as a "family limited partnership" (FLP), and a "family limited liability company" (FLLC). Although FLPs and FLLCs are generally the entities of choice for a family's investments or businesses, the closely held corporation should not be ignored, especially in a trade or business activity. Also, in some cases, a trust may be a more appropriate vehicle for the client's planning needs. As with most planning, consideration of each client's situation is necessary before an entity is chosen.

PRACTICE TIP: *Terminology*. The author disfavors the terms "family limited partnership" and "family limited liability company" in partnership documentation. The term "family" has no legal meaning and may have acquired a pejorative connotation for some IRS personnel.

© The Regents of the University of California

§1.3 C. Typical Planning Situations and Concerns

Family business entities can be used in a variety of situations. The typical client who uses the estate planning advantages of the FLP, FLLC, or closely held corporation is likely to have a significant net worth, often exceeding $7 million, which allows the client to comfortably give away assets that will use all or a significant portion of the client's applicable unified credit for gift and estate tax purposes. See California Estate Planning, chap 10 (Cal CEB 2002). Tax savings are realized because of valuation discounts and because potential future appreciation is transferred out of the client's estate. The cost of implementing the technique can easily exceed $20,000, given that the cost of appraisals alone can exceed $10,000.

A client is often best served by using a team of advisers, including an attorney, an accountant, and a financial or investment adviser. In addition to advising the client, the attorney often coordinates the entire effort with specific responsibility, at the very least, for (1) drafting the partnership agreement for an LP, the operating agreement for an LLC, or the corporate formation documents for a closely held corporation; (2) preparing and filing the required state organizational forms; (3) selecting and transferring assets to the entity; and (4) interacting with the appraisers and other advisers.

PRACTICE TIP: *Annual exclusion gifts*. A gift of an interest in a family business entity can qualify for the IRC §2503(b) $13,000 annual exclusion for gifts, depending on the structure of the entity and the terms of the gift. See California Estate Planning, chap 10 (Cal CEB 2002). Practitioners should be mindful that a gift must first satisfy the requirements for the annual exclusion. In *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664, the Tax Court held that gifts of LLC membership units were gifts of future interests that did not qualify for annual gift tax exclusions. The units could not be transferred without the manager's consent, and donors could not prove that there would be a current steady flow of income to the donees. But see IRS Letter Ruling 199944003 (gifts of partnership interests qualified for annual exclusion because partners had sufficient rights to make the interests qualify as present interests). In addition, a practical difficulty with gifting interests in family business entities as annual exclusion gifts is documenting the value for adequate disclosure on a gift tax return. See §1.40. Given the cost of appraisals, making gifts of such interests only as annual exclusion gifts may not be cost-effective if the client wants to utilize valuation discounts.

In a typical case, a married couple with children might contribute real property or securities, or both, to a limited partnership, receiving back all of the general and limited partnership interests. The couple then makes one or more gifts of limited partnership interests to their children or to trusts for their children. They usually want to continue to control the assets transferred to the FLP by keeping the general partner interests, although doing so may have negative estate tax consequences. See §1.37. Generally, because of valuation discounts for lack of control (minority interest) and lack of marketability, the value of a limited partner interest for gift tax purposes will be significantly less than the corresponding prorata share of the value of the underlying partnership assets.

An explanation giving the amount of and factual basis for the claimed discounts must be attached to the federal gift tax return. See §1.40. The IRS has consistently attacked the loss of value through valuation discounts, believing them to be artificially manufactured strictly for gift and estate tax purposes. As a result, specialized appraisals of the gifted interests, as well as appraisals of any hard-to-value underlying assets (*e.g.,* real property), are generally required to adequately document and sustain the claimed gift tax valuation.

At death, the interests in an entity included in the decedent's estate can also be entitled to valuation discounts. Unlike the valuation of gifts of partial interests of a larger whole, which are valued independently of each other, the whole of the interest included in the estate is valued for estate tax purposes even if it is devised in multiple parts. If the decedent had a controlling interest at death, or an ability to cause the entity to dissolve, the applicable valuation discounts may be reduced or eliminated. As a result, it is often advisable to make lifetime gifts to reduce a controlling interest to a noncontrolling interest. But see *Estate of Elizabeth B. Murphy,* TC Memo 1990-472, discussed in §1.30. In addition, practitioners must plan for the possible application of IRC §2036(a). See §1.37.

PRACTICE TIP: *Assignee interests*. Practitioners may wish to consider advising the client to gift assignee interests only. The assignee of an LP or LLC interest generally has economic rights only, with the result that an assignee interest may be valued even lower than the corresponding LP or LLC interest. See *Adams v U.S.* (5th Cir 2000) 218 F3d 383; *Estate of McLendon* (5th Cir 1995) 96-1 USTC ¶60,220, 77 AFTR2d 666; *Estate of Ethel S. Nowell,* TC Memo 1999-15. But see *Jane Z. Astleford,* TC Memo 2008-128 (substance over form doctrine applied to treat assignee interest of general partner as general partnership interest). The author generally does not use the assignee technique because it is often not consistent with clients' nontax goals. Recent legislative proposals may also eliminate any transfer tax advantages derived from assignee interests. For further discussion of the proposals, see §1.28.

The tax law in the area using family business entities is evolving, and any transaction entered into may encounter changes in the statutory or case law. The IRS considers valuation discounts for interests in family business entities to be aggressive tax planning and has shown that it will challenge them on a variety of grounds. From time to time, legislation has been proposed that limits the applicability of valuation discounts to interests in these entities, and recent case law also may limit the tax savings from valuation discounts (see §1.37). Clients should be informed of the IRS's attitude, and of any proposed legislation, and cautioned that perceived gift and estate tax benefits may not occur. It is also possible that the planned estate tax repeal could make tax savings illusory. See California Estate Planning, chap 10 (Cal CEB 2002). The clients most likely to be satisfied with organizing family business entities will thus be those who also have other business or nontax goals. See §§1.42-1.49.

© The Regents of the University of California

§1.4 D. Ethical Considerations: Conflicts and Competence

As with any professional engagement, the attorney must identify his or her client. If the attorney is to represent multiple clients, appropriate written waivers of potential conflicts of interest should be obtained. See Cal Rules of Prof Cond 3-310(C). Estate planning attorneys should be familiar with these rules as they apply to husband and wife. When forming a family business entity, the attorney needs to be sensitive to the fact that potential clients and, therefore, conflicts, include all of the other owners of the entity and the entity itself.

Before advising a client on any matter, an attorney must have the skill and expertise to competently handle the matter. Cal Rules of Prof Cond 3-110. In addition to estate planning expertise, an attorney advising a client regarding the formation of a business entity must have competence in the substantive law regarding the various kinds of business entities, as well as expertise in other areas of law such as taxation, securities, and real property law. If an attorney does not have the requisite competence, he or she can either (1) associate with or professionally consult with another attorney who is reasonably believed to be competent, or (2) acquire sufficient learning to become competent before performance is required. Cal Rules of Prof Cond 3-110(C).

© The Regents of the University of California

§1.5 II. CHOICE OF ENTITY AND FORMATION ISSUES

Once a decision has been made to use a family business entity as an estate planning vehicle, the adviser must then help the client choose the appropriate form of business entity. Generally, the client will choose a family limited partnership (FLP) or family limited liability company (FLLC). Attorneys generally advise clients to avoid general partnerships because of the unlimited liability that each partner has for the obligations of the partnership and for acts of other partners committed within the scope of the partnership business.

© The Regents of the University of California

§1.6 A. Limited Partnerships

A partnership is an association of two or more persons to carry on, as co-owners, a business for profit. Corp C §16101(9); IRC §7701(a); Treas Reg §301.7701-2(c). Limited partnerships are governed by the California Revised Limited Partnership Act (CRLPA) (Corp C §§15611-15723) and the Limited Partnership Act of 2008 (Re-RULPA) (Corp C §§15900-15912.07). Re-RULPA applies to existing limited partnerships that elect to be covered by its provisions as of January 1, 2007, limited partnerships formed after January 1, 2008, and all limited partnerships after January 1, 2010. Corp C §15912.06.

A limited partnership (LP) is a partnership in which one or more of the partners are general partners and one or more of the partners are limited partners. Corp C §15901.02(q) (Corp C §15611(r) for nonelecting limited partnerships until January 1, 2010). General partners have control of the limited partnership and make all management decisions. They also have unlimited personal liability for the partnership's obligations, although a creditor may be required to satisfy a judgment first from the assets of the limited partnership. Corp C §§15904.04, 15904.05 (Corp C §15643 for nonelecting limited partnerships until January 1, 2010). Limited partners have no control over any partnership business decisions, although the partnership agreement or state law may provide the limited partners with voting rights on certain internal partnership issues. As a consequence of the lack of control, limited partners have no personal liability for any obligations of the partnership. Corp C §15903.03 (Corp C §15632(a)-(b) for nonelecting limited partnerships until January 1, 2010).

To form a limited partnership in California, the limited partnership must file a Form LP-1 (Certificate of Limited Partnership) with the California Secretary of State. Corp C §15902.01(a) (Corp C §15621(a) for nonelecting limited partnerships until January 1, 2010). California charges LPs an annual franchise tax of $800. Rev & T C §§17935(a), 23153(d)(1). For further discussion of LPs, see Advising California Partnerships (3d ed Cal CEB 1999).

Partnerships are "flow-through" entities for income tax purposes. In general, the income of the partnership is allocated to its partners in proportion to their interests in the partnership. This allocation and numerous other partnership income tax rules are set forth in Subchapter K of the Internal Revenue Code (IRC §§701-777) and the voluminous regulations applicable to these statutes. These rules are generally considered to be some of the most complex in tax law.

© The Regents of the University of California

§1.7 1. Choice of General Partner

An LP must have one or more general partners. A general partner can be an individual or another entity, such as a corporation or an LLC. In family estate planning, the older generation usually wants to continue to control or manage the assets transferred to the LP by acting as the general partner. Sometimes, if the older generation does not want to risk the personal liability associated with acting as a general partner, the older generation's members will form a corporation or LLC to act as the general partner, instead of using individual general partners. In this way, all individuals are protected from personal liability because the individuals only own limited partnership interests (assuming that the entity is not disregarded, *e.g.,* for not observing corporate formalities or for not being adequately capitalized).

The identity of the general partners often has a direct impact on whether a discount will be applied to a general partnership interest in the estate of a decedent. If the decedent had the unilateral power to dissolve the partnership, his or her partnership interests are likely to be valued at nondiscounted liquidation values. For this reason, many practitioners prefer to have more than one general partner, if the general partners are individuals, or one general partner that is an entity not controlled by the transferring client.

EXAMPLE: In California, a 50-percent owner of a corporation has the power to cause a voluntary dissolution of the corporation. If a corporation is the general partner of an LP, its dissolution would be treated as a withdrawal, which would cause the LP to dissolve unless there is another general partner or there is a vote of the majority in interest of the limited partners to continue the partnership. Corp C §§15906.03, 15908.01(c) (Corp C §§15642, 15681 for nonelecting limited partnerships until January 1, 2010; Corp C §15724). Thus, if a decedent could have caused a corporate general partner to dissolve, the decedent's interest in the limited partnership is likely to be valued at nondiscounted liquidation values.

© The Regents of the University of California

§1.8 2. Requirement of Two or More Persons

It now seems clear that an individual and his or her revocable trust cannot meet the requirement that a partnership must have two or more partners, although it should be possible for an individual and his or her solely owned corporation to form a partnership. See Rev Rul 2004-77, 2004-2 Cum Bull 119 (partnership formed by an individual and a disregarded entity that may be valid under state law will not be taxed as a partnership under federal income tax laws). It is unclear whether a husband and wife can form a partnership through their jointly established living trust. However, it does seem clear that the sole partners of a partnership can consist of husband and wife acting individually or through a combination of separately owned trusts and jointly owned trusts. See, *e.g.,* Rev Rul 58-243, 1958-1 Cum Bull 255. See also IRC §7701(a)(1).

© The Regents of the University of California

§1.9 B. Limited Liability Companies

Limited liability companies are a hybrid of the corporation and the limited partnership. LLCs with two or more members are treated as partnerships for federal income tax purposes unless they elect otherwise. See Treas Reg §§301.7701-1—301.7701-3. This means that they are also "flow-through" entities for income tax purposes. See §1.6. Single-member LLCs, which are allowed in California, are ignored for federal income tax purposes unless they elect to be taxed as corporations. This format does, however, allow a single individual to establish a business entity. Treas Reg §301.7701-3. An LLC is managed by all of its members, unless the articles of organization provide that the LLC will have one or more managers who may, but need not, be members. Corp C §§17150-17151. In the family planning context, the older generation can retain control of the management of the LLC by naming themselves as the managers.

An LLC provides limited liability for all of its members, managers, and officers for any judgment, debt, obligation, or liability of the LLC (to the same extent as corporations provide for their shareholders, directors, and officers). Corp C §§17101(a)-(b), 17158(a). However, as with shareholders of a corporation, LLC members are generally subject to liability on such grounds as alter ego liability or piercing the corporate veil (*e.g.,* because of the failure to adequately capitalize). See Corp C §17101(b). Because of the lack of case law interpreting the LLC statutes, some conservative attorneys still believe that the limited liability provided by LLCs may not prove to be as protective as the limited liability of a corporation. However, the prevailing view appears to be that LLCs provide the same level of protection as a corporation.

To form an LLC in California, the LLC must file a Form LLC-1 (Articles of Organization) with the California Secretary of State. Corp C §17050(a). California charges LLCs an annual franchise tax of $800, and an annual fee on gross income of $250,000 or more. Rev & T C §§17941(a), 17942, 23153(d)(2). For further discussion of LLCs, see Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

© The Regents of the University of California

§1.10 C. Corporations

Corporations have historically been used for operating businesses principally because the individual managers and owners of the corporation are not personally liable for the corporation's obligations. See Organizing Corporations in California, chap 1 (3d ed Cal CEB 2001). Corporations have also been used for passive investment activities, although various income tax rules, such as the double taxation of income (first at the corporate level and again when distributed to shareholders as dividends), discourage that use. Corporations are taxed as separate entities for income tax purposes, unless they make an "S corporation" election under IRC §1361. An S corporation is treated as a pass-through entity for tax purposes under the rules of IRC §§1361-1379. California recognizes S corporation status for income tax purposes. Rev & T C §§23800-23813. There are, however, significant differences between the pass-through taxation applicable to S corporations and that applicable to partnerships. See Organizing Corps, chap 1. To form a California corporation, articles of incorporation must be filed with the Secretary of State, and bylaws must be prepared. For further discussion of corporations, see Organizing Corps; Counseling California Corporations (3d ed Cal CEB 2008).

© The Regents of the University of California

D. Choosing Entity

§1.11 1. Corporation Versus FLP or FLLC

The choice for a family business entity usually is narrowed down to the FLP or FLLC relatively easily. The corporate form tends to be less popular for several reasons:

- A corporation is not a pass-through entity for income tax purposes unless the S corporation election is made. Even if the S corporation election is made, an S corporation is not as flexible for income tax purposes as the LP or LLC, and there are limits on who may be a shareholder (certain trusts may not qualify or may have to make elections that subject them to higher tax rates).

- A corporation is subject to capital gains taxes on dissolution. IRC §336. (If an S corporation is going to sell the corporate assets, the dissolution tax can be minimized or eliminated.)

- The corporate entity has less organizational flexibility than does either the LP or LLC. A corporation must comply with the required corporate formalities under state law, such as annual shareholders' and directors' meetings and written minutes, to ensure that the entity is not disregarded for tax, liability, or other purposes. Neither the LP nor the LLC is required to observe these formalities.

NOTE: Although some practitioners believe that the corporation may be less of a target for IRS scrutiny, several of the estate and gift tax cases regarding discounts have involved closely held corporations.

© The Regents of the University of California

§1.12 2. FLP Versus FLLC

The choice between an LP and an LLC depends on a variety of individual factors. For example, although California LLCs originally were required to have two or more members, California law now allows the formation of single-member LLCs. Corp C §17050(b). This difference may make the LLC more attractive than the LP in cases when only one person must form the entity. In addition, if limited liability is the most important factor for a family and most family members will be involved in management, the LLC may be more appropriate because limited liability is extended to all members and managers of an LLC. If a limited partner were to participate in management of an LP, he or she would lose the protection of limited liability. Although the general partner of an LLC can include family members who want to manage, greater liability protection is afforded by the LLC form.

On the other hand, the California fee on the gross revenues of an LC above $250,000 may make the LP more attractive if the entity is expected to generate income above that amount. See §1.9.

There may be less risk in planning with LPs because there is more case law involving partnerships than the relatively newer LLC form. Perhaps more importantly, certain aspects of California law, *e.g.*, the more stringent requirements for dissolution (see §1.29), may make the LP more likely to receive a valuation discount, which can be important for gift and estate tax purposes.

© The Regents of the University of California

§1.13 E. Choosing Assets

In general, a family business entity can be formed with any kind of investment assets, such as securities, real property, and operating businesses. However, there are some traps for the unwary.

Investment company. The formation of an LP, LLC, or closely held corporation is a nontaxable event (IRC §§351(a), 721(a)) unless the contributions on formation are made to an entity deemed an "investment company" (IRC §§351(e), 721(b)). A contribution is treated as being made to an investment company if (1) it results in "diversification" of the transferor's interests, and (2) more than 80 percent of the value of the entity's assets are readily marketable stocks or securities (including money). Treas Reg §1.351-1(c)(1).

This limitation can be avoided in several ways. Care can be taken that marketable securities do not exceed 80 percent of the value of the entity's assets. Diversification does not occur if there is only one transferor, if there are two or more transferors who contribute identical assets (Treas Reg §1.351-1(c)(5)) and the diversification is below specified levels, or if each of several transferors transfers a diversified portfolio (Treas Reg §1.351-1(c)(6)). The identical-asset requirement will often not be difficult if a husband and wife are forming the partnership, because their assets may be identical to begin with if their estate is substantially community property. In any event, formation with closely held business interests or real property avoids the issue entirely.

Business purpose. To receive partnership tax treatment, an LP or LLC must have an investment or financial purpose. IRC §7701(a)(2). Therefore, it may be difficult to justify placing personal use assets, such as a primary residence or vacation home, in an LP or LLC, unless the assets are converted to business use through, for example, the payment of rent. (There is also an issue that the transferor's continued use of property transferred to an LP or LLC may cause the property to be included in the transferor's estate under IRC §2036. For further discussion of IRC §2036, see §1.37 and California Estate Planning, chap 10 (Cal CEB 2002).)

Restrictions on stock. Practitioners may also encounter a variety of issues when transferring property to a family business entity. For example, if a client wants to transfer shares in a corporation to the entity, the practitioner must first determine if there are any restrictions on transferring the stock that may exist under a shareholders' agreement or securities law. This determination may require examining the corporate documents and consulting with the corporation's attorneys or other attorneys.

Encumbrances. The contribution of encumbered assets to an LP, LLC, or closely held corporation raises a number of tax issues. In particular, when the liability assumed by the entity exceeds the adjusted basis of the asset, the contribution of the property can cause the recognition of gain to the transferor. IRC §§357(c), 731(a), 752(b). Gain recognition depends on a variety of factors, including whether the obligation is recourse or nonrecourse, and whether the contributing partner remains ultimately responsible for the obligation. See Treas Reg §1.752-2(b). See also Advising California Partnerships, chaps 7-8 (3d ed Cal CEB 1999).

© The Regents of the University of California

III. ESTATE AND GIFT TAXES

§1.14 A. Valuation Discounts

Gift and estate taxes are excise taxes on the transfer of property from one person (the transferor) to another person, based on the fair market value of the property transferred. IRC §§2001, 2031, 2501, 2512. See California Estate Planning, chap 10 (Cal CEB 2002). Fair market value is generally defined as the price that a willing buyer and a willing seller would agree to, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts. Treas Reg §§20.2031-1(b), 25.2512-1. Naturally, taxpayers and the IRS often disagree about fair market value, and valuation disputes have been part of gift and estate tax cases for decades.

The fair market value of a minority or noncontrolling interest in a closely held entity, whether a limited partnership, limited liability company, or corporation, is usually less than the corresponding proportionate share of the value of the assets of the entity. *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999; *Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion); *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57. The rationale for this is that the owner of a minority or noncontrolling interest suffers from a lack of control and cannot easily realize his or her investment in the entity. In addition, the market for a closely held business interest is generally limited. Thus, interests in closely held businesses are allowed valuation discounts for lack of control and lack of marketability. Appraisers may also increase the lack of marketability discount for other characteristics, such as poor portfolio diversity. Courts have allowed additional discounts in valuing the stock of corporations owning assets having a low-income tax basis. See, *e.g., Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, acq 1999-1 Cum Bull xix; *Estate of Artemus D. Davis* (1998) 110 TC 530. See also *Estate of Dunn v Commissioner* (5th Cir 2002) 301 F3d 339; *Estate of Jameson v Commissioner* (5th Cir 2001) 267 F3d 366.

While the determination of fair market value for estate tax purposes in an entity may seem to save substantial sums, particular attention must be paid to the effect of IRC §2036(a). See §1.37-1.37E.

© The Regents of the University of California

§1.15 1. Lack of Marketability

The discount for lack of marketability is based on the general absence of a ready market for interests in closely held entities. See *Adams v U.S.* (5th Cir 2000) 218 F3d 383; *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57. This discount should apply even to a controlling owner if the assets of the entity are not liquid or are otherwise difficult to sell. *Estate of Charles Russell Bennett,* TC Memo 1993-34; *Estate of Gregg Maxcy,* TC Memo 1969-158, rev'd on other grounds (5th Cir 1971) 441 F2d 192. The IRS, however, may challenge a discount if the controlling owner can force a liquidation of the entity and if the assets of the entity are liquid assets. *Adams v U.S.*, *supra*. Quantifying and substantiating the discount for gift and estate tax purposes will generally require an appraisal.

© The Regents of the University of California

§1.16 2. Lack of Control

The discount for lack of control applies to a noncontrolling interest in a closely held business. This discount reflects an inability to compel liquidation of an entity and realize a prorata share of the entity's net asset value. Often, but not always, a noncontrolling interest is a minority interest (generally thought of as less than 50-percent ownership in an entity), and the discount is often called a minority interest discount. *Virginia Z. Harwood* (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion); *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57.

The concept of control seems simple but may encompass a variety of issues, including control of distributions, day-to-day and future management of the entity, and, perhaps most importantly, the ability to force a liquidation. In most planning situations, a noncontrolling interest will have none of these characteristics. This is particularly true for a limited partner who, by law, cannot participate in management. As with lack of marketability (see §1.15), quantifying and substantiating the discount for gift and estate tax purposes will generally require an appraisal. In *Estate of Godley v Commissioner* (4th Cir 2002) 286 F3d 210, the court held that the Tax Court's refusal to allow a lack-of-control discount for a 50-percent general partnership interest was not clearly erroneous. The partnership rented housing to elderly persons under government contracts that assured partnership income, and the partnership agreement mandated annual distribution of net cash flow, which could not be changed without a vote of 75 percent of the shares.

Appraisal methodologies and concepts are also being challenged by the courts, and appraisers are questioning hitherto accepted principles. See, *e.g., Peter S. Peracchio,* TC Memo 2003-280 (allowing 15-percent minority interest discount and 24-percent marketability discount for gifts of interests in FLP holding real estate and marketable securities); *Clarissa W. Lappo,* TC Memo 2003-258 (allowing 6-percent minority interest discount and 25-percent lack-of-marketability discount for FLP funded with cash, money market funds, and publicly traded securities). In *Estate of Helen A. Deputy*, TC Memo 2003-176, the court used a six-factor "matrix" employed by the estate's expert as a "guide" to determine the amount of a combined 30-percent discount for lack of marketability and minority interest, but did not necessarily accept the approach. Practitioners should be aware of these developments and, perhaps more importantly, choose appraisers who are also willing to adapt to these changing conditions.

© The Regents of the University of California

§1.17 3. Mathematics of Discounts

Discounts are generally applied in sequential fashion, as illustrated below.

EXAMPLE: Assume that a client gifts a 30-percent limited partner interest in an FLP to each of two children; the fair market value of the entity is $5,000,000; the discount for lack of marketability is 20 percent; the discount for lack of control is 30 percent; and the gift tax rate is 45 percent.

Without applying any valuation discounts, the value of each gift is $1,500,000 ($5,000,000 × 0.30), the total value of the two gifts is $3,000,000, and the total gift tax (without any credits or exemptions) is $1,350,000. However, the total discounted value of the gifts, which the donor claims for gift tax purposes, is $1,680,000 ($3,000,000 less 20-percent discount for lack of marketability = $2,400,000; $2,400,000 less 30-percent discount for lack of control = $1,680,000). Thus, the discount in the aggregate is 44 percent ($1,320,000 divided by $3,000,000). The gift tax (without any credits or exemptions) is 45 percent of $1,680,000, or $756,000. Thus, the valuation discounts result in a gift tax savings of $594,000.

Furthermore, an additional benefit may be realized at the client's death because the discounts could apply to the client's retained 40-percent interest. In that event, there would be additional tax savings of $396,000 ($2,000,000 initial retained value of FLP, less 20-percent discount = $1,600,000; $1,600,000 less 30-percent discount = $1,120,000; $1,120,000 × 45-percent estate tax rate = $504,000), compared to nondiscounted estate tax of $900,000 ($2,000,000 × 45-percent estate tax rate). As a result, the total transfer tax savings could be $990,000, in addition to the savings that may occur as the result of transferring potential future appreciation out of the client's estate.

© The Regents of the University of California

§1.18 4. Income Tax Consequences

Assuming that a valuation discount is successfully obtained by a decedent's estate for an interest in a family business entity, a potential countervailing tax issue for the recipient of the property should be considered. The value shown on the federal estate tax return will also be the basis of the interest in the hands of the recipient (and of the underlying assets in the entity with respect to that interest if an IRC §754 election is made for a partnership or LLC). IRC §1014; Treas Reg §1.1014-1(a). As a result, additional capital gains taxes may be incurred if the interest in or property of the entity is sold. In addition, basis carries over for any gifted interest in an entity, as with any other gift, unless fair market value is less than basis. In that situation, basis is reduced to that fair market value. See IRC §1015. If estate tax rates are substantially reduced, the potential of increased capital gains taxes at both the state and federal level may actually outweigh the estate tax savings.

© The Regents of the University of California

§1.19 B. Valuation Premiums

In some situations, the fair market value of an interest in a family business entity includes a valuation premium because the interest is a controlling interest or a minority interest with the potential of control. These valuation premiums are called the control premium and the swing vote premium.

© The Regents of the University of California

§1.20 1. Control Premium

Just as discounts apply to noncontrolling interests, a control premium may apply to a controlling interest in a family business entity. To some extent, the control premium is simply the converse of the minority interest, and reflects that a willing buyer would pay more for a controlling interest in an entity. See *Estate of Simplot v Commissioner* (9th Cir 2001) 249 F3d 1191 (Ninth Circuit implicitly acknowledges concept of control premium, but holds that control premium cannot be applied unless it can be shown that purchaser would be able to use control in such a way as to assure an economic advantage).

© The Regents of the University of California

§1.21 2. Swing Vote Premium

A variation of the control premium is the swing vote premium, which adds value to a minority voting interest that has swing vote potential. The basis of the swing vote premium is that the owner of a minority voting interest has the potential to combine with other interest holders to gain majority voting control of the entity. See, *e.g., Estate of Clara S. Roeder Winkler,* TC Memo 1989-231 (5-percent swing vote premium allowed). Conversely, a lack-of-control discount may be allowed for nonvoting interests in an entity.

For the swing vote premium to apply, the holdings of all the owners must be considered. For example, in IRS Letter Ruling 9436005, the IRS asserted that an increase in value (or at least a reduction in the minority interest discount) had to be applied to a block of shares that had swing vote potential. In this ruling, the donor had made a gift of 30-percent interests in a closely held corporation to each of his three children. The IRS ruled that the value of each gift was enhanced by the simultaneous transfers, because any two of the donees could join and control the corporation. In *Estate of Clara S. Roeder Winkler, supra,* there was a 50-percent block, a 40-percent block, and the decedent's 10-percent block. The court found additional value in the 10-percent block because a hypothetical buyer of that block could combine with one of the other two shareholders to either gain or block control of the company. However, in *Estate of Cyril I. Magnin,* TC Memo 2001-31, no swing vote premium was allowed because it could not be shown that a hypothetical buyer could combine with another shareholder and gain control.

© The Regents of the University of California

C. IRC Chapter 14 Valuation Rules: IRC §§2701-2704

§1.22 1. Introduction

For decades, taxpayers used various interests in corporate entities to attempt to shift some portion of the value of a group of assets to younger generations. These transactions were generally referred to as "estate freeze" transactions because the goal often was to shift all future appreciation to the younger generation while keeping a significant income interest for the older generation. A common approach was to issue preferred stock to the older generation and common stock to the younger generation. The preferred stock retained preferred distribution, liquidation, and voting rights, while the common stock had all the rights to appreciation. Usually, the common stock was valued at a very low percentage of the value of the entire entity.

Another approach was to transfer all rights except the right to vote. In *Byrum v U.S.* (SD Ohio 1970) 311 F Supp 892, aff'd (6th Cir 1971) 440 F2d 949, aff'd (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382, the district court held that the taxpayer's retention of the right to vote transferred shares was not a retention of the entire value of the shares for estate tax purposes. The IRS had asserted that retaining the right to vote was an impermissible retained interest under IRC §2036(a). In response to the *Byrum* decision, Congress enacted IRC §2036(b), which provides that retention of the right to vote shares in a controlled corporation (defined in IRC §2036(b)(2) as ownership by the decedent of at least 20 percent of the voting stock) will be considered a retained interest that causes the value of the shares to be included in the transferor's estate. Enactment of this section, however, did not stop the use of numerous other estate freeze techniques.

In 1990, Congress enacted the special valuation rules of Chapter 14 of the Internal Revenue Code (IRC §§2701-2704). In general, the Chapter 14 rules attack traditional estate freeze techniques, as well as a number of other intrafamily transactions, in which the value of a transferred interest was considered by the IRS to be undervalued for gift and estate tax purposes. The mechanics of Chapter 14 generally involve ignoring certain rights, restrictions, or retained interests when valuing a transferred interest. Despite these rules, however, gifts of interests in family business entities can still be eligible for valuation discounts if the entity is properly structured, the gifted interest is a minority or noncontrolling interest, and the interest has the same economic rights as other interests in the entity.

© The Regents of the University of California

§1.23 a. IRC §2701

Internal Revenue Code §2701 applies to the valuation of interests in corporations and partnerships, and, by extension, LLCs. It generally seeks to prevent a low valuation of intrafamily transfers of such interests to a younger generation when the older generation retains a preferred interest with certain distribution, liquidation, put, call, or conversion rights. Such a retained interest is called an "applicable retained interest." Unless certain requirements are met, the value of an applicable retained interest is deemed to be zero and the value of the transferred interests will equal the value of the entire entity.

To be considered to have value, a retained interest must have a "qualified payment right." A qualified payment right requires actual payments to be made at least annually, at a fixed rate or amount, with an interest penalty attached if the payments are not made. The cash flow requirement to make the payment is unrelenting and generally makes operating within this rule unattractive.

Internal Revenue Code §2701 does not apply if (1) there are readily available market quotations to value a transferred interest or an applicable retained interest, (2) the retained interest is of the same class, or proportionally the same, as the transferred interest, or (3) the transfer proportionately reduces each class of interest held by the donor, the donor's spouse, and their ancestors in the aggregate. IRC §2701(a)(1)-(2); Treas Reg §25.2701-1(c)-(d). The section also will not apply if a corporation, partnership, or LLC has only one class of outstanding stock or interests. See Treas Reg §25.2701-1(c)(3).

For further discussion of IRC §2701, see California Estate Planning, chap 25 (Cal CEB 2002).

© The Regents of the University of California

§1.24 b. IRC §2702

Internal Revenue Code §2702 generally applies to interests in trusts or trust-like arrangements in which the grantor has a retained interest and has made a gift of an interest in the trust to family members. As in IRC §2701, unless certain requirements are met, the value of a retained interest is deemed to be zero for gift tax purposes. This statute has essentially eliminated the use of the "grantor retained income trust" (GRIT) among family members, which, in the IRS's view, allowed the grantor to value the gifted remainder interest in a manner that, although actuarially correct for gift tax purposes, could be undervalued when measured against actual economic performance.

The statute makes an exception, however, for a "qualified personal residence trust" (QPRT), which allows the grantor to continue living in his or her residence for a specified term following transfer of the residence to the trust. IRC §2702(a)-(b). The statute also permits the continued use of the "grantor retained annuity trust" (GRAT) and "grantor retained unitrust" (GRUT). In general, GRATs and GRUTs can provide transfer tax savings if the grantor outlives the term of the trust, and if the underlying property appreciates at a rate that is higher than the applicable federal rate under IRC §7520, which is used to value the remainder interest for gift tax purposes at the time the trust is created. Treas Reg §25.2702-2(b). For further discussion of these trusts, see California Estate Planning, chap 25 (Cal CEB 2002).

© The Regents of the University of California

§1.25 c. IRC §2703

Internal Revenue Code §2703 applies to agreements among family members involving rights to acquire or use property at a price less than the fair market value of the property, or restrictions on the right to sell or use property. The rights or restrictions may be contained in options; buy-sell agreements; partnership, operating, or shareholders' agreements; or any other agreement. Under IRC §2703, these rights or restrictions will be disregarded in valuing the transferred property for transfer tax purposes unless the option, agreement, right, or restriction meets the following requirements: (1) It is a bona fide business arrangement; (2) it is not a device to pass on wealth to members of the decedent's family at a reduced value; and (3) its terms are comparable to similar agreements among unrelated persons in arm's-length transactions. IRC §2703(b).

NOTE: Although an option or buy-sell agreement among unrelated parties can reduce the value of property for estate tax purposes, such an agreement among family members could not do so even before the enactment of IRC §2703, unless the agreement met certain requirements set forth in Treas Reg §20.2031-2(h) and case law. See, *e.g.*, *Estate of True v Commissioner* (10th Cir 2004) 390 F3d 1210. Under Treas Reg §20.2031-2(h) and case law, to avoid being disregarded in valuing property, a buy-sell agreement already had to meet the first two requirements of IRC §2703, *i.e.,* be a bona fide business arrangement and not be a device to pass on wealth at a reduced value. Many planners believed that the third requirement added in IRC §2703 (comparability of terms) would be almost impossible to meet. See *Thomas H. Holman* (2008) 130 TC 170 (IRS expert's view that terms of agreement not comparable to similar arrangements entered in arm's-length transactions because no one would enter into such agreement at arm's length), discussed in §1.34.

© The Regents of the University of California

§1.26 d. IRC §2704

The following sections concern the treatment for gift and estate tax purposes of (1) lapses of voting or liquidation rights and (2) transfers of interests with liquidation restrictions. A thorough understanding of IRC §2704 is critical to the proper structuring of family business entities for gift and estate tax valuation purposes.

© The Regents of the University of California

§1.27 (1) IRC §2704(a)

In general, IRC §2704(a) treats the lapse of voting or liquidation rights in a business entity as either a transfer by gift or a transfer includable in the decedent's gross estate, depending on when the lapse occurs. This section applies only if the individual with the rights and his or her family (as defined in IRC §2704(c)(2)) control the entity both before and after the lapse. Control is based on ownership of at least a 50-percent interest in the entity. IRC §§2701(b)(2), 2704(c)(1); Treas Reg §25.2701-2(b)(5). The effect of IRC §2704(a), if it applies, will often be to eliminate the discounts for minority interest or lack of marketability, or both. This rule prevents a reduction in the value of interests in closely held entities transferred by a donor whose retained interests have voting or liquidation rights that lapse after the transfer. This statute was enacted in response to *Estate of Daniel J. Harrison, Jr.,* TC Memo 1987-8, in which the decedent's right to force liquidation lapsed at death and the right was not taken into account in determining the value of the estate.

Generally, IRC §2704(a) will not apply if an individual does not possess a voting or liquidation right. As a result, this section should be relatively easy to plan around.

© The Regents of the University of California

§1.28 (2) IRC §2704(b)

In planning for valuation discounts, IRC §2704(b) is probably more troublesome than IRC §2704(a). It provides that for purposes of valuing a family business interest that is transferred to a member of the transferor's family, any "applicable restriction" will be disregarded to the extent that it is more restrictive than the limitations that would apply under federal or state law in the absence of the restriction. IRC §2704(b)(3)(B); Treas Reg §25.2704-2(b). An applicable restriction is one that (1) restricts the ability to liquidate the entity, and (2) either (a) lapses after the transfer, or (b) can be removed by the transferor or his or her family members. This section applies only if the transferor and his or her family (as defined in IRC §2704(c)(2)) control the entity before the transfer. Control is based on ownership of at least a 50-percent interest in the entity. IRC §§2701(b)(2), 2704(b), (c)(1); Treas Reg §§25.2701-2(b)(5), 25.2704-2(b). If the donor or decedent would have the right to liquidate the entity in the absence of the applicable restriction, the effect of IRC §2704(b) will be to eliminate entity-level valuation discounts.

NOTE: Planners should be aware of legislative proposals that would modify or enlarge the application of IRC §2704(b). The Obama administration's proposal authorizes the IRS to issue regulations that disregard certain techniques or may seek to standardize restrictions by allowing safe harbor provisions, perhaps envisioning standardized discounts. See Treasury Department document General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, p 121, at http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf. See discussion of proposal in Denham, *Obama Administration Revenue Proposals Would "Zero Out" Short-Term GRATs and Curb Family Entity Valuation Freeze Techniques,* 30 CEB Est Plan R 133 (June 2009).

© The Regents of the University of California

§1.29 (3) Dissolution

Under California limited partnership law, except as otherwise provided in the partnership agreement, a California LP will be dissolved on the approval of all general partners and a majority in interest of the limited partners. Corp C §15908.01(b) (Corp C §15681(b) for nonelecting limited partnerships until January 1, 2010; see §1.6). Thus, a provision in a California limited partnership agreement requiring the approval of all limited partners to liquidate the partnership would be an applicable restriction under IRC §2704(b) because the California default rule requires approval of only a majority of the limited partnership interests (along with the vote of all general partners). Similarly, California limited liability company law provides that the vote of a majority in interest of the members will dissolve an LLC, unless a greater percentage of the voting interests is specified in the LLC's articles of organization or operating agreement. Corp C §17350(b). However, any supermajority dissolution requirement in the organizing documents would be treated as an applicable restriction. As a result, it is the author's belief that the limited partnership rules, requiring unanimous consent of the general partners to dissolve, are more restrictive than the limited liability company rules and are, therefore, more likely to sustain valuation discounts. California corporations will be dissolved on the vote of shareholders with 50 percent or more of the voting power. Corp C §1900(a). This percentage cannot be changed.

© The Regents of the University of California

§1.30 2. IRS Attacks on Valuation Discounts

The IRS has consistently attacked the valuation discounts that practitioners have asserted for partnerships and other closely held enterprises, especially when the enterprises are not traditional businesses. See, *e.g.,* IRS Letter Rulings 9723009, 9725002, 9730004, and 9842003, citing *Estate of Elizabeth B. Murphy,* TC Memo 1990-472. In *Estate of Murphy,* 18 days before dying, the decedent gifted about 2 percent of her stock in a closely held corporation to her children, reducing her controlling 51-percent interest to a 49-percent minority interest. The court held that a minority discount could not be applied because the sole purpose and effect of fragmenting the control block of stock was to reduce federal tax. The court stated that nothing of substance was intended to change as a result of the transfers, and the gifts did not significantly affect the decedent's beneficial interest except to reduce estate taxes.

The IRS has also used the Chapter 14 rules as well as a host of other arguments in its attack. In Field Service Advice 200143004, the IRS reasserted several arguments against valuation discounts in family-owned entities, despite a number of defeats in the courts. The IRS position includes arguments that:

- The entity lacks economic substance and should be disregarded for gift or estate tax purposes (a substance-over-form argument);
- Internal Revenue Code §2703 requires all family business entities to be ignored for valuation purposes;
- Any restriction in excess of restrictions applicable under state law should be ignored for valuation purposes under IRC §2704(b);
- The assets of the entity are included in the estate of the transferor under IRC §2036(a);
- A gift can occur on formation of an FLP if the total value of all partnership interests, valued individually, are not equal to the total value of the underlying property (although the IRS recommended against using this argument in Field Service Advice 200143004, it remains an argument that it may raise); and
- In the alternative, the claimed discounts for lack of control and lack of marketability will be considered excessive in certain cases.

Given IRS antipathy towards the valuation of family business entities, the practitioner should advise clients forming these entities of the risks involved in entering into what the IRS regards as aggressive tax planning. The practitioner should also have a thorough understanding of the federal and state laws that affect the existence of this valuation approach. The IRS has achieved the most success in the courts using IRC §2036(a)(1) and, in a surprising turn of events, IRC §2036(a)(2). See §1.37-1.37E.

© The Regents of the University of California

§1.31 3. Court Responses to IRS Arguments

A number of cases in which the IRS has challenged valuation discounts on a variety of grounds have held for the taxpayer and allowed valuation discounts for interests in family business entities for gift and estate tax purposes, although the amount of some of the discounts has been adjusted by the court. Other cases have held for the IRS. Some of these cases are discussed in §§1.32-1.36.

© The Regents of the University of California

§1.32 a. IRC §2704(b) Argument

The IRS has argued that the existence of a term in an FLP agreement, *i.e.,* a specified date when the entity would dissolve and liquidate, is an applicable restriction under IRC §2704(b) if state law permits a limited partner to withdraw from a limited partnership that does not have a stated term. Similarly, the IRS might argue that there is an applicable restriction for a California limited partnership if the partnership agreement restricts the right of a majority limited partner to remove the general partner. The right to remove a general partner is granted, in the absence of a contrary provision in the partnership agreement, under Corp C §15636(f)(2). The applicable restriction is supposedly present because the right to remove, according to this argument, gives the majority limited partner the ability to coerce the general partner to consent to dissolution under Corp C §15681. However, under the Limited Partnership Act of 2008 (Corp C §§15900-15912.07; see §1.6), a majority of limited partners no longer has the right to remove a general partner. See generally Corp C §§15903.01-15903.07.

PRACTICE TIP: Practitioners with clients who will retain a majority interest in a partnership may wish to consider forming the partnership under the Limited Partnership Act of 2008 or under the law of a state that also does not give the majority partner the right to remove the general partner and that does not give a limited partner the right to withdraw from a partnership that does not have a stated term.

Although two Tax Court cases had held that the IRS could apply the applicable restriction test only to dissolution statutes in determining whether an applicable restriction exists, both cases have ultimately been resolved on other grounds and may no longer be persuasive authority. In *Baine P. Kerr* (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490, the Fifth Circuit held that IRC §2704(b) did not apply because an unrelated party, the University of Texas, was a limited partner and the family therefore did not control the partnership for purposes of §2704(b). Thus, the question of whether the term limit was an applicable restriction was not reached and the holding in the Tax Court decision now appears to be simply dictum. In *Estate of Morton B. Harper*, TC Memo 2000-202, the court relied on the Tax Court's holding in *Kerr* in reaching a similar result. However, in *Estate of Morton B. Harper,* TC Memo 2002-121, the court held that IRC §2036(a) applied to the taxpayer. See §1.37A. Thus, the result in the first *Harper* decision, although apparently still good law, is now based on dictum in another case and has been rendered moot (although apparently not overruled) by subsequent proceedings in the same case. Although the arguments raised in the two Tax Court cases may still be valid, the issues are far from settled under existing case law.

© The Regents of the University of California

§1.33 b. Lack of Economic Substance Argument

A second IRS argument is that an FLP should be disregarded for federal tax purposes because it lacks economic substance. This argument was dealt a defeat in *Ina F. Knight* (2000) 115 TC 506, in which the Tax Court refused to ignore the existence of an FLP for failure to have economic substance. Instead, the court found that state law governs the existence of property rights, that the partnership was a valid partnership under state law, and that because a potential buyer would not ignore the partnership, the partnership should be recognized in valuing the partnership interest for federal estate and gift tax purposes.

The Tax Court, however, agreed with the IRS and disallowed a minority interest discount for lack of economic substance in *Estate of Elizabeth B. Murphy,* TC Memo 1990-472. See §1.30. It is important to note that the court referred to several writings from the donor's professional advisers exhorting her to make the gift in order to reduce her interest for the purpose of obtaining a minority interest discount. See also *Estate of Theodore R. Thompson,* TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367.

In contrast to *Estate of Murphy,* the Tax Court did not apply the lack of economic substance argument in *Estate of Anthony J. Frank, Sr.*, TC Memo 1995-132, in which the decedent's son, acting under a power of attorney, made a gift of more than 18 percent of the decedent's stock in a closely held corporation to the decedent's wife just 2 days before the decedent's death. The court ignored the motive for the gift because a much smaller gift would have accomplished the goal if tax avoidance had been the only motive for the gift.

© The Regents of the University of California

§1.34 c. IRC §2703 Argument

The IRS has argued that the partnership form itself is the restriction that must be disregarded under IRC §2703 for valuation purposes. This argument was struck down in *Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion), in which the court held that it would not disregard the taxpayer's FLP because it was validly formed under state law. See also *Estate of W.W. Jones II* (2001) 116 TC 121. But see *Smith III v U.S.* (WD Pa 2004) 2004-2 USTC ¶60,488, 94 AFTR2d 5283 (FLP agreement provision concerning partnership's right to pay purchase price in installments if it exercises right of first refusal disregarded for valuation purposes unless IRC §2703(b) safe harbor provision applies). This principle was first set forth by the Tax Court in *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279 (*Strangi I)*, but the court of appeals remanded the case to determine whether IRC §2036(a) applied. On remand, see *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*). See §1.37A. Thus, the precedential value of *Strangi I* is in question.

At least one court has used IRC §2703 to disregard the valuation of an appraiser who relied on the buy-sell restriction in the partnership agreement in determining the value of a limited partnership interest. See *Smith III v U.S., supra*. More recently, in *Thomas H. Holman* (2008) 130 TC 170, the court found that the buy-sell provisions of a limited partnership agreement operated to restrict the ability of the limited partners to reach their proportionate share of the underlying value of the partnership. Therefore, the court deemed the buy-sell provisions to be a device to pass wealth to other family members, even though the buy-back provisions required the units to be priced at fair market value, and held that the IRS properly ignored the restrictions when valuing the limited partnership units, because the values of the interests of the remaining partners would increase if the partnership were to purchase limited partnership units transferred in violation of the agreement. (The IRS expert also took the view that the terms of the agreement were not comparable to similar arrangements entered into by persons in arm's-length transactions for the simple reason that no one would ever enter into the agreement at arm's length.) The court concluded that the restrictions were not part of a "bona fide business arrangement" in any event, as required by IRC §2703(b), because the restrictions were intended to prevent dissipation of property by the limited partners—not to preserve a business. It remains to be seen whether other courts will accept the premise that buy-sell provisions that require use of fair market value are properly characterized as a device to pass wealth to family members, or that there is a substantial difference in value when fair market value is the standard in the buy-sell agreement.

© The Regents of the University of California

§1.35 d. Lost Value Argument

The Tax Court in *Estate of Albert Strangi* (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom *Gulig v Commissioner* (5th Cir 2002) 293 F3d 279 (*Strangi I*), on remand, *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*), also invalidated the IRS argument that seeks to find a gift on formation of the FLP by arguing that the "lost" value has to go somewhere. The court held that there was no gift on the formation of the partnership, which occurred 2 months before the decedent's death, principally because the decedent received credit for all of his contributions in his capital account with the partnership. See also *Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion); *Estate of W.W. Jones II* (2001) 116 TC 121.

© The Regents of the University of California

§1.36 e. Family Attribution

To some extent, IRS complaints about valuation discounts applicable to family business entities have focused on the perception that a family will act together, and that if control is held in the family unit, discounts are illusory (this argument underlies the Chapter 14 rules). After a number of defeats in the courts, however, the IRS issued Rev Rul 93-12, 1993-1 Cum Bull 202, in which it conceded that the value of an intrafamily gift of a minority interest in a corporation is determined by looking only at the interest transferred and not by aggregating the voting power held by all family members. *Estate of Woodbury G. Andrews* (1982) 79 TC 938, superseded by statute on other grounds as stated in *Eisenberg v Commissioner* (2d Cir 1998) 155 F3d 50, 57. See also *Propstra v U.S.* (9th Cir 1982) 680 F2d 1248; *Estate of Bright v U.S.* (5th Cir 1981) 658 F2d 999; *Estate of Elizabeth M. Lee* (1978) 69 TC 860, nonacq 1980-2 Cum Bull 2. By extension, this also applies to valuations of FLP and FLLC interests.

© The Regents of the University of California

§1.37 4. IRS Litigation Using IRC §2036(a)

Although the IRS has yet to succeed in court on any of its more esoteric theories designed to invalidate all family limited partnerships, significant IRS victories under IRC §2036(a) have had a major impact on partnership planning. See *Estate of Wayne C. Bongard* (2005) 124 TC 95 (transfer to partnership ineffective for estate tax purposes); *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*).

Internal Revenue Code §2036(a) provides that a decedent's gross estate includes any property transferred by the decedent, excluding transfers by bona fide sale for full and adequate consideration, in which the decedent retained either (1) the possession or enjoyment of the property or right to income of the property, or (2) the right, alone or in conjunction with any other person, to designate the persons who could possess or enjoy the property or its income. See §1.37A. Most planners are now convinced that partnerships should have a legitimate and significant nontax or business purpose. See §1.37B. In addition, planners may have to take other measures to lessen the impact of these cases in any partnership when discounts are desired or gifts are made. See §1.37C. Planners also should consider the possible application of the step-transaction doctrine. See §1.37D.

Whenever a taxpayer will retain any interest in a partnership or other business entity, the practitioner will have to consider the impact of IRC §2036(a). Documenting the non-tax purpose promises to be the most effective way to ensure this section will not be applied. See §1.37E.

© The Regents of the University of California

§1.37A a. Application of IRC §2036(a)(1) and (a)(2)

It has always been clear that IRC §2036(a)(1) applies if the decedent had either an express or implied agreement to retain the enjoyment of property. See *Estate of Wayne C. Bongard* (2005) 124 TC 95; *Estate of Hilde E. Erickson,* TC Memo 2007-107; *Estate of Lorraine C. Disbrow,* TC Memo 2006-34; *Estate of Austin Korby,* TC Memo 2005-103, aff'd (8th Cir 2006) 471 F3d 848; *Estate of Virginia A. Bigelow,* TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955; *Estate of Lea K. Hillgren,* TC Memo 2004-46; *Estate of Ida Abraham,* TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26, cert denied (2006) 547 US 1178; *Estate of Theodore R. Thompson,* TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367; *Estate of Morton B. Harper,* TC Memo 2002-121. Now, as a result of the Tax Court opinion in *Strangi II* (*Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468), planners must also consider the effect of IRC §2036(a)(2) (not discussed in the Fifth Circuit decision).

Generally, §2036(a)(2) was thought to be more limited in scope than §2036(a)(1). Before *Strangi II,* it was believed that a general partner's duty to control and manage a partnership was insufficient to cause inclusion because of the fiduciary duties owed to the limited partners. See *U.S. v Byrum* (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382. See also IRS Letter Rulings 9415007, 9310039. The Tax Court opinion in *Strangi II* distinguished *Byrum* stating that the fiduciary duties in *Byrum* were far more significant than the fiduciary duties in *Strangi II*. The Tax Court noted the presence of unrelated shareholders and an independent trustee in *Byrum* compared with the absence of any non-family members in *Strangi II* and the fact that Strangi essentially owned all of the partnership. Without a meaningful fiduciary duty, the court held that Strangi's 47-percent interest in the corporate general partner allowed him (through his attorney-in-fact since Strangi was incapacitated at the time), in conjunction with the other shareholders, to control the income of the partnership, thereby justifying inclusion under §2036(a)(2) as well as having a retained income interest under §2036(a)(1). The Tax Court opinion in *Strangi II* also ignored the holding in *Estate of Abraham Cohen* (1982) 79 TC 1015, which held that IRC §2036(a)(2) did not apply to trustees of a Massachusetts business trust who had the power to declare dividends.

After *Strangi II*, and contrary to its holding on this point, the court in *Estate of Anna Mirowski*, TC Memo 2008-74, cited the general partner's fiduciary duties under Maryland law as a reason why IRC §2036(a)(2) did not apply to gifts of limited partnership units made to trusts for the decedent's daughters. See also *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257 (decedent's 50-percent interest in general partner not sufficient to make §2036(a)(2) apply). Neither case discussed the *Strangi II* language concerning intra-family fiduciary duties.

© The Regents of the University of California

§1.37B b. Significant Nontax or Business Purpose

Although some observers had feared that the IRS would try to apply IRC §2036(a)(2) to all family business entities, it is now relatively clear that if a taxpayer establishes a significant non-tax or business purpose for the formation of the business entity, §2036, including §2036(a)(2), will not apply. See *Turner v Commissioner* (3d Cir 2004) 382 F3d 367 (no legitimate business purpose); *Estate of Wayne C. Bongard* (2005) 124 TC 95 (one entity had business purposes; another entity did not); *Estate of Thelma G. Hurford,* TC Memo 2008-278 (no legitimate nontax purpose); *Estate of Anna Mirowski,* TC Memo 2008-74 (legitimate nontax purposes included limited liability and centralized management); *Estate of Charles Porter Schutt,* TC Memo 2005-126 (significant nontax purpose found when taxpayer wished to avoid diversification of particular publicly traded company's stock); *Estate of Virginia A. Bigelow,* TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955 (no legitimate nontax purpose; gift giving is testamentary in nature and cannot be legitimate nontax purpose); and *Estate of Eugene E. Stone III,* TC Memo 2003-309 (significant nontax purpose). These courts have held that if a taxpayer has a legitimate nontax purpose, it is a bona fide transfer for adequate consideration on formation of the partnership, thereby precluding the operation of §2036. However, the purpose must be real, not theoretical, and not simply recited in the partnership agreement.

The inquiry into whether a nontax purpose rises to the level required is factual and may turn to some extent on the nature of the underlying assets of the partnership. Operating businesses, agricultural concerns, and rental real property are among the types of assets that are often commonly held in limited partnerships or limited liability companies to limit liability, regardless of estate tax consequences. As a result, the author believes it will be easier to establish legitimate business purposes for entities holding these types of assets. Conversely, partnerships that hold only marketable securities may have difficulty showing legitimate nontax purposes. See, *e.g., Estate of Emma V. Jorgensen*, TC Memo 2009-66.

Several cases have examined limited liability as a legitimate nontax purpose. Although some of the cases have held that the taxpayer did not establish that there was any liability from which protection was needed, none of them held that limiting liability was itself not a legitimate nontax purpose. See *Estate of Virginia A. Bigelow, supra; Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*). Furthermore, at least two cases have specifically held that limiting liability was a legitimate nontax purpose for the particular taxpayer in question. See *Kimbell v U.S.* (5th Cir 2004) 371 F3d 257; *Estate of Anna Mirowski, supra*. *Mirowski* involved partnership-owned patents that may have been subject to litigation, and *Kimbell* involved partnership-owned oil and gas properties, but it is not entirely clear from either opinion just how necessary the liability protection actually was. Although risks from liability connected with real property or operating businesses can be protected through insurance, clients are commonly advised to consider LPs and LLCs for additional liability protection. As a result, limiting liability should be a legitimate nontax purpose for these types of assets. See, *e.g., Keller v U.S.* (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015 (purpose of protecting assets from divorce was legitimate and satisfied bona fide sale exception of IRS §2036(a)). Regardless of the type of asset, it is good practice to document the client's significant nontax purposes.

© The Regents of the University of California

§1.37C c. Other Strategies to Avoid IRC §2036(a)

There are also strategies that might prevent the application of §2036(a)(2) even if a court does not find significant nontax purposes. For example, control over distributions might be given to a general partner other than the taxpayer while allowing the taxpayer to retain input over management issues. It is the author's belief that if other family members have significant ownership interests, fiduciary duties should be recognized, making the application of §2036(a)(2) more difficult. Nevertheless, planners must not only consider strategies designed to highlight these fiduciary duties or to isolate control over income, but must also consider how these strategies can be integrated with the client's nontax goals. In addition, because the courts have treated the transfer of too much of a taxpayer's property to a partnership as evidence of an implied agreement to retain enjoyment, taxpayers undertaking partnership planning should be advised to keep a substantial amount of their assets outside of the partnership and available to support their lifestyle and meet their obligations. See, *e.g., Estate of Virginia A. Bigelow,* TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955. One court has allowed the taxpayer to look at distributions expected from the partnership that are proportional to the taxpayer's non-transferred interest in determining whether sufficient assets were kept to meet expected obligations. *Estate of Anna Mirowski,* TC Memo 2008-74.

Some practitioners also believe that the right to vote on liquidations is a power, alone or in conjunction with others, to control the income or property of the partnership. Under the Limited Partnership Act of 2008 (Corp C §§15900-15912.07; see §1.6), it appears that California will allow restrictions on a limited partner's right to vote on liquidations. Therefore, if a practitioner believes that this voting right will be characterized as a power to control, the partnership agreement could be drafted to eliminate the right. Again, practitioners will need to consider whether such a provision will serve the client's nontax goals.

In some cases, the IRS may fail to raise the §2036 argument, which has resulted in at least one unusual result. See *Estate of Webster E. Kelley,* TC Memo 2005-235 (12-percent minority discount and 23-percent marketability discount applied even though only partnership asset was cash).

© The Regents of the University of California

§1.37D d. Application of Step-Transaction Doctrine

The IRS has also successfully applied the step transaction doctrine to gifts of partnership interests. See *Senda v Commissioner* (8th Cir 2006) 433 F3d 1044. In *Senda*, the court found that the taxpayers made indirect gifts of stock, not gifts of partnership interests, because the transfer of partnership interests were made in an integrated transaction at the same time as the transfer of assets to the partnership.

Some commentators believe the door has now been opened to application of the doctrine to a transfer of property to the partnership *followed* by a gift of partnership interests if the two actions were part of a single "integrated transaction." As a result, it may be difficult to determine how long a practitioner should wait once assets have been transferred to a partnership before gifts or other transfers of partnership interests are made in order to avoid application of the step-transaction doctrine. See *Eight Circuit Decides to Send a Message: Step-Transaction Doctrine Can Apply to FLP Contribution/Gift Transactions*, 27 CEB Est Plan Rep 93 (Feb. 2006). However, fears that the doctrine could be broadly applied in this context may be overblown. See, *e.g.*, *Thomas H. Holman* (2008) 130 TC 170 (gifts of limited partnership units made 6 days after formation of partnership not subject to step-transaction doctrine, because of possible market fluctuations in underlying publicly held stock). But see *Heckerman v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,578, 104 AFTR2d 5551, and *Linton v U.S.* (WD Wash 2009) 2009-2 USTC ¶60,575, 104 AFTR2d 5176, in each of which the court held that donors made indirect gifts of assets transferred to an LLC on the same day that they transferred LLC units to trusts for children. Even if there had been some evidence that the funding of the LLC occurred first, the funding of the LLC and the transfers of LLC units should be deemed to occur simultaneously under the step-transaction doctrine. The court in both cases relied on *Senda* and distinguished *Holman*.

Additional cases applying this doctrine are likely to be decided. See, *e.g., Suzanne J. Pierre* (2009) 133 TC No. 2 (application of step-transaction doctrine specifically reserved for separate decision). *Pierre* is significant for other reasons as well because the court held that gifts of membership interests in a single-member LLC were gifts of LLC interests rather than gifts of the underlying assets of the LLC. The court held that state law concepts control the nature of property interests, and therefore the IRS's disregarded-entity rules applicable to single-member LLCs do not apply for purposes of the federal gift tax.

© The Regents of the University of California

§1.37E 5. Planning Responses to IRC §2036(a) Attacks

The IRS attack using IRC §2036(a) has generated extensive discussion among estate planners using partnerships and a number of planning responses. First and foremost, practitioners should realize that partnerships without any serious nontax objectives are unlikely to achieve the desired tax consequences. In addition, practitioners also need to counsel clients to take precautions to avoid some of the more obvious problems that are highlighted by these cases. Some of the precautions that should be considered are as follows:

- *Avoid disproportionate distributions.* Prorata distributions show that all partners have a stake in the partnership. Disproportionate distributions, especially going back to the original transferor, are strong evidence of an implied agreement that the transferor may retain use of the assets.

- *Retain funds outside the partnership for personal use.* The client should retain sufficient assets to completely fund his or her lifestyle. If the client has to rely on the partnership for living expenses, a court may find it very easy to infer that there was an agreement that the funds would be available for that purpose and are therefore an impermissible retained interest. It should be noted, however, that many practitioners believe it should be permissible for the client to rely on his or her *proportionate* share of partnership income for living expenses.

- *Respect partnership formalities.* Obviously, separate partnership accounts and records should be kept. Holding meetings and taking minutes is also probably a good idea. Again, careful practitioners will admonish clients to operate the partnership as a business (even if the business is investing passive assets) and to avoid using partnership assets for any purpose that does not benefit the partnership. In addition, contribution of property to the partnership should be properly documented and occur before any transfers.

- *Have business purpose and economic substance.* The partnership's investment policies and activities should be documented. The investment policy should be tailored to the partnership as a whole and not to the original owner, although the continuation of certain family investment values can be a significant nontax purpose. In some cases, the underlying activities will be ongoing businesses, which should easily satisfy the business purpose requirement, especially if the original business was not otherwise in an entity.

- *Isolate control.* The partnership can be structured so that control over distributions is held by someone other than the original owner. For example, the partnership could have two general partners and the second general partner, who should not be the client, could be given exclusive authority over distributions. This precaution may be insufficient if the *Strangi II* holding is expanded to cover any situation in which two persons in a partnership (whether limited or general) can somehow combine to make a decision to control income. Ironically, this precaution might not ordinarily be taken in most business partnerships, but might be prudent when the only members of the partnership are related, even if the underlying asset is an ongoing and active business. It may also be prudent to eliminate the right to vote on liquidations for any class of interest that the client will retain.

- *Have all partners contribute.* Having a number of partners contribute more than a *de minimis* amount at the initial formation of the partnership may help the partnership qualify for the full and adequate consideration exception to IRC §2036(a)(2). From a practical standpoint, having each partner risk some capital should also help indicate that the economic arrangement was a true partnership.

- *Consider transferring all interests.* Although some of the initial appeal of the partnership may have been the ability to retain control, it could make sense for existing partnerships to consider a transfer of all of the donor's interest in the partnership because IRC §2036(a) is an estate tax statute and has no application for gift tax purposes. Practitioners should be careful in these situations, however, to consider the 3-year rule of IRC §2035, which generally applies to gifts of retained interests under IRC §2036(a); as a result, it may be preferable to sell, rather than gift, remaining partnership interests.

These suggestions make clear that partnership planning, more than ever, must encompass nontax and business motivations. Practitioners also must be vigilant to watch for future developments in this area, as additional court rulings appear likely.

© The Regents of the University of California

D. Appraisals

§1.38 1. Documenting Discount

Although it is clear that the minority interest discount and the discount for lack of marketability apply to family business entities, the taxpayer has the burden of showing the amount of the discount. *Estate of Edgar A. Berg,* TC Memo 1991-279, aff'd in part and rev'd in part on other grounds (8th Cir 1992) 976 F2d 1163. For all practical purposes, the taxpayer must hire a qualified appraiser in order to prove the amount of each discount. Appraisals must address and document the particular situation and cannot merely rely on previous cases to establish the amount of discounts. Often, the presence of appraisals can present significant hurdles to the IRS or establish the bona fides of a particular transaction. See, *e.g., McCord v Commissioner* (5th Cir 2006) 461 F3d 614 (appraisal of value documenting transfer between charity and children of taxpayers was validated).

© The Regents of the University of California

§1.39 2. Contents of Appraisal

Generally, appraisers employ a variety of methods, including the income approach, which analyzes the cash flow of the entity, and the market approach, which compares the entity in question to similar entities. Appraisers must look at the particular fact of the entity being valued and relate their conclusions to the facts. Courts are not bound to accept the opinion of any expert witness and have shown an increasing tendency to reach conclusions about value using their own analysis. See, *e.g.*, *Thomas H. Holman* (2008) 130 TC 170, discussed in §1.34. The Tax Court in particular seems willing to substitute its own judgment for that of any appraiser, whether for the IRS or the taxpayer, if the court believes the experts have not properly supported their conclusions. See, *e.g., Estate of Josephine T. Thompson,* TC Memo 2004-174, vacated and remanded (2d Cir 2007) 499 F3d 129, cert denied (2008) ___ US ___, 171 L Ed 2d 863, 128 S Ct 2932 (but affirming Tax Court valuation except for double counting); *Bernard Mandelbaum,* TC Memo 1995-255, aff'd (3d Cir 1996) 91 F3d 124. In *Mandelbaum*, the court decided that neither the IRS's expert nor the taxpayer's expert had presented a persuasive case. The ruling then set forth a list of ten nonexclusive factors to determine the lack of marketability discount for stock of a closely held corporation. Some appraisers have adopted the *Mandelbaum* factors, while others have criticized the court's approach.

In Rev Rul 59-60, 1959-1 Cum Bull 237, the IRS set forth factors to be used to determine the fair market value of interests in closely held corporations. These factors are virtually identical to those listed in Treas Reg §25.2512-2(f)(2), and have been widely accepted in determining fair market value.

Appraisers also must now be aware of potential penalties for appraisals in which assets are undervalued by 40 percent or more relative to the value such assets are ultimately determined to have for transfer tax purposes. See IRC §§6662(h)(2)(C), 6695A.

NOTE: Practitioners should carefully review appraisals for any factual inaccuracies. Although questioning certain technical issues may be difficult, practitioners should at least make sure that the appraisal is analyzing the particular company in question and not simply reaching an arbitrary conclusion.

Practitioners may also want to request appraisers to consider the value of limited partnership units without regard to restrictions on transfer contained in the partnership agreement or other governing documents, as a way of taking into account the possible impact of the ruling in *Thomas H. Holman* (2008) 130 TC 170 (see §1.34).

© The Regents of the University of California

§1.40 3. Adequate Disclosure Requirement for Gift Tax Return

Gifts are reported on IRS Form 709, the federal gift tax return. The statute of limitations that applies to reported gifts is 3 years after the date of filing the return. IRC §6501(a). Once the period of limitations expires, the amount of that gift as reported on the return may not be adjusted for purposes of determining future gift and estate tax liability. IRC §6501(c)(9). Under IRC §6501(c)(9), however, a gift must be adequately disclosed on a gift tax return in order to commence the running of the period of limitations on assessment with respect to the gift. Therefore, most practitioners advise that gift tax returns should always be filed to begin the running of the statute of limitations. For further discussion of gift tax returns, see California Estate Planning, chap 10 (Cal CEB 2002). Although some transfers may not be gifts (*e.g.,* sales for fair market value when discounts are taken), a question added to the federal estate tax return on transfers or sales of interests in partnerships, limited liability companies, or closely held corporations to a trust may now make it prudent to file gift tax returns for any such transfers.

The regulations under IRC §6501 provide guidance on what constitutes adequate disclosure. The information that is required includes:

- A description of the transferred property and any consideration received by the transferor;
- The identity of, and relationship between, the transferor and each transferee; and
- If an appraiser is not used, a detailed description of the method used to determine the fair market value of property transferred, including any financial data that were utilized; any restrictions on the transferred property that were considered in determining the fair market value of the property; and a description of any discounts, such as discounts for blockage, minority, or fractional interests, and lack of marketability, claimed in valuing the property; or
- If an appraiser is used, a detailed description of the information considered in arriving at the conclusion sufficient to allow replication; the valuation method used and the procedure in using the method; the appraiser's qualifications; and a statement that (1) the appraiser holds himself or herself out to the public as an appraiser, (2) the appraiser is qualified, (3) the appraiser is not the donor, related to the donor, or employed by the donor, and (4) gives the specific basis for the valuation, such as comparable sales, used in the appraisal. See Treas Reg §301.6501(c)-1(f)(2)-(3) for the complete list of requirements.

© The Regents of the University of California

§1.40A E. Circular 230

Practitioners must also be aware of Circular 230 (31 CFR pt 10) whenever providing tax advice on which a taxpayer intends to rely. Under 31 CFR §10.35, certain written advice (including email) concerning federal tax issues must comply with detailed requirements relating to the use of reasonable factual assumptions and the need to provide a conclusion with respect to each significant issue considered in the opinion. To avoid problems under Circular 230, the practitioner may instead include a prominent disclosure that any written tax advice was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer. For further discussion of Circular 230, see California Estate Planning §2.7A (Cal CEB 2002); Drafting California Irrevocable Trusts §1.7A (3d ed Cal CEB 1997); *Tax Return Preparer Penalties: New Proposed Regulations and a Possible Statutory Change,* 30 CEB Est Plan Rep 5 (Aug. 2008); *"Revised Revised" Final Regulations and Continuing Debate—The Ongoing Circular 230 Controversy,* 26 CEB Est Plan Rep 157 (June 2005); *The New Circular 230 Regulations: Keeping the Tempest in the Teapot,* 26 CEB Est Plan Rep 97 (Feb. 2005).

© The Regents of the University of California

§1.41 IV. STRUCTURING AND FORMING FAMILY BUSINESS ENTITY

The structure of the family business entity will depend on the interpersonal relationships of the family and how the structure impacts value for tax purposes. Although drawing conclusions from the numerous valuation cases is perhaps difficult, practitioners must address the question of whether structuring a transaction primarily or solely for estate tax purposes is impermissible, given the attention in court opinions to estate planning recommendations by advisers to families regarding valuation issues. Some of the cases seem to indicate that an entity only need be validly formed and recognized under state law for the entity to be recognized and the transaction to be valid for transfer tax purposes. See, *e.g., Church v U.S.* (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion); *Ina F. Knight* (2000) 115 TC 506. Other cases seem to disallow transfer tax consequences to transactions when the only motivation is to reduce taxation. See, *e.g., Estate of Elizabeth B. Murphy,* TC Memo 1990-472. However, it is now clear that IRC §2036(a) can be applied to any partnership that does not have significant nontax purposes. Accordingly, the author recommends that the contemplated family business entity have clearly documented, significant business or nontax purposes in addition to estate tax savings attributes. Internal Revenue Code §2703 must also be considered.

© The Regents of the University of California

§1.42 A. Business Purpose

Family business entities can meet a number of goals. The possible gift and estate tax savings may attract clients, but, if tax savings are the only motive, clients may ultimately be disappointed and the entity may be disregarded for tax purposes for lacking substance. When properly used, a family business entity accomplishes one or more of a number of nontax goals, some of which are discussed in the following sections.

© The Regents of the University of California

§1.43 1. Centralized Management and Control

The general partners of an FLP and the outside or member-managers of an FLLC manage the entity. As a result, the general partners and managers make all investment and distribution decisions, although these decisions are subject to fiduciary obligations to the other owners. This authority provides centralized management for the assets, which can be important in maintaining value. Centralized management also means that the general partners or managers have control, which is often important to clients who wish to confer wealth on their children but are concerned about how that wealth would be managed. Control can be critical when assets are illiquid or require particular knowledge to properly manage. Of course, control over more liquid investments can also be important when the client wishes to maintain a certain investment philosophy. An FLP or FLLC can prove useful to parents who have concerns regarding children about to become entitled to significant custodial accounts. The custodian can invest the account in the FLP or FLLC so that the asset ultimately given to the child is a limited partnership interest or nonmanaging member LLC interest that can be controlled by the general partner or managers.

© The Regents of the University of California

§1.44 2. Pooling of Assets

By maintaining a larger pool of assets to invest, the family business entity may be able to obtain better investment opportunities, have a wider range of investment risk, or have more sophisticated investments.

© The Regents of the University of California

§1.45 3. Investment Training

Younger family members may have little or no idea regarding the investment philosophy of an older generation. The family business entity can be a training ground for the younger generation. The older generation can remain in control while educating the younger generation about managing investments or interacting with investment professionals who manage the family's wealth. Over time, the older generation may in fact wish to turn over management to the younger generation.

© The Regents of the University of California

§1.46 4. Family Values and Bonding

For some families, the family business entity can be an environment in which family values are reinforced and a serious pursuit—the family's financial welfare—is shared among several generations. These values may include responsible financial management, socially responsible investing, particular industry biases, and asset allocation strategies. The practitioner should be aware that if a family takes this purpose seriously, as it should, serious conflicts between generations can develop or be revealed. Of course, deeper familial relationships can also be developed.

© The Regents of the University of California

§1.47 5. Family Businesses

The family business entity can also serve as a family investment vehicle that invests in business ventures of the various owners. Although an ill-advised investment could cause serious conflicts between the owners, a well-thought-out business plan may help younger family members succeed in business.

© The Regents of the University of California

§1.48 6. Limited Liability

The owners and managers of a family business, other than the general partners of an LP, are not personally liable for the obligations of the entity. In situations in which some family members are in management and others are not, sharing ownership of the family business through a family business entity provides a liability shield for the nonparticipating family members.

© The Regents of the University of California

§1.49 7. Asset Protection

One of the more important benefits of the family business entity is that the assets of the entity are generally not subject to the creditors of its owners. Although a creditor of a limited partner or LLC member may be able to obtain a charging order or even foreclose on a partnership or membership interest, the creditor has only the rights of an assignee, which gives the creditor only the right to receive the distributions that would otherwise have been made. A charging order does not provide the creditor with the power to exercise any rights or powers of a partner or member. CCP §§699.720, 708.310; Corp C §§15907.02, 15907.03, 17302. Although a limited partnership interest or a membership interest subject to a charging order may be foreclosed, the party acquiring the interest in the foreclosure sale is only entitled to become an assignee in the entity. Corp C §§15907.02, 15907.03, 17302(b). Furthermore, if an interest is foreclosed, the creditor may also be treated as the owner of the interest for income tax purposes. The partnership or operating agreement will generally provide that if a charging order applies to a partner or member's interest, the other partners or members, or the partnership or LLC will have an option to acquire or redeem the affected partnership interest.

© The Regents of the University of California

B. California Law

§1.50 1. Restrictions on Liquidation Rights

For valuation purposes, knowledge of state default law is important in drafting organizational instruments for family business entities. Often the key issue in maintaining a valuation discount concerns restrictions on liquidation rights for the interest being valued. For example, if a partner has the right to liquidate the partnership, his or her partnership interest would generally be given a value that is equal to the prorata value of the underlying assets to the extent that the partnership is composed of easily liquidated assets. As discussed above, liquidation rights can be limited in the partnership agreement but disregarded for valuation purposes under IRC §2704(b) if state default law provides a more lenient liquidation standard. See §1.28. A gift of a minority interest in an LP, LLC, or closely held corporation will generally be entitled to valuation discounts because minority interests almost never have a right to force liquidation of the entity under the entity's governing instruments or under applicable state law.

NOTE: *Real property.* A prorata share of a partnership composed of real property should still receive a discount because a fractional share of real property also suffers from a lack of marketability.

© The Regents of the University of California

§1.51 2. Restrictions on Transfers

The partnership agreement or other governing document of the family business entity will generally have provisions restricting the transferability of the interests in the entity, which functions to preclude unwanted intrusions by outsiders. Although a donor may want to completely restrict transferability, doing so may result in an inability to treat the gift of a partnership interest as a present interest for gift tax purposes. Usually, the entity can accomplish the purpose sought by such restrictions by providing for a right of first refusal exercisable by the entity or the other owners for the fair market value as determined by an appraisal. The fair market value will generally reflect valuation discounts, although the IRS may seek to disregard the impact of the restrictions on sale or the valuation discounts. The option can also provide for a lengthy installment payout to reduce the immediate cash flow issues for the buyers.

© The Regents of the University of California

§1.52 3. Real Property Tax

The transfer of real property to a family business entity should not be done without considering and planning for the property tax consequences of the transfer. Generally, the transfer of property to an LP, LLC, or closely held corporation will not cause a reassessment for property tax purposes as long as the transfer results solely in a change in the method of holding title to the real property, and proportional ownership interests are the same after the transfer. Rev & T C §62(a)(2). See California Estate Planning, chap 15 (Cal CEB 2002). When a transfer is excluded from reassessment on its transfer to the entity, reassessment will occur as soon as more than 50 percent of the ownership interests in the entity are transferred on a cumulative basis. Rev & T C §64(d).

When the partners consist of parents and children, a comparison between the reassessment possibilities associated with transfers to an entity and the exclusion from reassessment available through the "parent-child exclusion" should be made. The parent-child exclusion exempts from reassessment a principal residence transferred between parents and children and the first $1 million of assessed value of any other real property. Rev & T C §63.1(a)(1)-(2). See California Estate Planning, chap 15 (Cal CEB 2002). Because assessed value can be significantly less than fair market value, the exclusion can be especially beneficial.

Practitioners may wish to consider direct transfers of fractional interests in real property either before or after the partnership is formed if it is desired to have the parent hold a minority interest in the partnerships without causing reassessment. If the transfer occurs after the partnership is formed, the real property would have to be proportionally distributed to its partners before the direct transfer of the fractional interest.

NOTE: *Documentary transfer tax.* Practitioners should also consider whether a documentary transfer tax will be imposed by a county or city on the transfer of property to a family business entity. Rev & T C §11911. Generally, a transfer to an LP or LLC is exempt from documentary transfer tax to the same extent as the transaction would be exempt from real property tax reassessment. Rev & T C §11925(d).

Title insurance. Practitioners should also consider whether a transfer to a partnership or other entity will invalidate existing title insurance and, if so, whether that impact is significant. See *Kwok v Transnation Title Ins. Co.* (2009) 170 CA4th 1562, 89 CR3d 141.

© The Regents of the University of California

§1.53 4. Other Substantive Law Considerations

In addition to estate planning expertise, an attorney advising a client regarding the formation of a business entity must have competence in the substantive law regarding the various kinds of business entities, as well as expertise in other areas of law such as taxation, securities, and real property law. Except as noted above, extensive discussion of these areas is beyond the scope of this chapter. For a discussion of the ethical issues involved in determining an attorney's competence in the formation of business entities, see §1.4.

© The Regents of the University of California

§1.54 C. Family Business Entity Formation Combined With Other Estate Planning Techniques

The use of FLPs, FLLCs, and closely held corporations with other estate planning techniques is beyond the scope of this chapter. However, practitioners should be aware that different combinations of estate planning techniques are often used that result in larger tax savings. For example, FLPs and FLLCs are often used in conjunction with sales to a defective grantor trust, grantor retained annuity trust (GRAT), charitable remainder trust (CRT), or charitable lead trust (CLT). For further discussion of these techniques, see California Estate Planning, chaps 23, 25 (Cal CEB 2002). FLPs and FLLCs can also be useful when transfers of life insurance are being considered because of the exception from the "transfer for value" rule under IRC §101(a)(2)(B). For further discussion, see Estate Plan, chap 19.

© The Regents of the University of California

2

Succession Planning for Family Businesses

Denise M. Riley

I. INTRODUCTION §2.1

II. BUY-SELL AGREEMENTS §2.2

A. Giving Owner Right of First Refusal §2.3

B. Evaluating Methods of Funding Buy-Out §2.4

C. Using Agreement to Fix Estate Tax Value §2.5

1. Bona Fide Business Arrangement §2.6

2. Not a Device to Transfer Property to Family Members for Less Than Full and Adequate Consideration §2.7

3. Evidence of Comparable Arm's-Length Transactions §2.8

4. Lifetime Restrictions §2.9

5. Obligation of Estate to Sell §2.10

6. Determinable Selling Price §2.11

D. Using Agreement to Allocate Marital Property §2.12

III. CORPORATE RECAPITALIZATION §2.13

A. Step One: Amending Articles of Incorporation §2.14

B. Step Two: Transferring Nonvoting Common Stock §2.15

IV. LIFETIME TRANSFER STRATEGIES §2.16

A. Grantor Retained Annuity Trust (GRAT) §2.17

1. GRAT Basics §2.18

a. Gift Tax Considerations in Using GRATs §2.19

b. Estate Tax Considerations in Using GRATs §2.20

c. GRAT Treated as Grantor Trust §2.21

d. GST Tax Considerations in Using GRATs §2.22

2. Zeroed-Out GRATs (*Walton* GRATS) §2.23

3. Practical Considerations in Using GRATs §2.24

B. Installment Sale to Grantor Trust §2.25

1. Basic Grantor Trust Strategy §2.26

a. Income Tax Considerations in Sale to Grantor Trust §2.27

b. Gift Tax Considerations in Sale to Grantor Trust §2.28

2. Comparison of Sale to Grantor Trust With GRAT §2.29

3. Combining Sale to Grantor Trust With GRAT §2.30

C. Transfer of S Corporation Interests to Trust §2.31

1. Grantor Trust as S Corporation Shareholder §2.32

2. Qualified Subchapter S Trust (QSST) §2.33

a. Income Distribution Requirement for QSST §2.34

b. QSST Treated as Grantor Trust §2.35

3. Electing Small Business Trust (ESBT) §2.36

a. ESBT Election §2.37

b. Termination of ESBT §2.38

D. Valuation of Gifts for Federal Gift Tax Purposes §2.39

V. PAYMENT OF ESTATE TAXES §2.40

A. IRC §303 Redemption §2.41

B. IRC §6166 Estate Tax Deferral §2.42

© The Regents of the University of California

§2.1 I. INTRODUCTION

Succession planning for the family business is particularly challenging because of the array of issues it presents. Among those issues are transfer tax and income tax considerations; the determination of who should succeed to ownership and management of the business; when interests in the business should be transferred and how the transferred interests should be held; and providing for family members who may not be active in the business. The presence of one or more nonfamily owners further complicates matters.

A succession strategy for a closely held business owner should be a long-term plan, including lifetime transfers as well as transfers at death, and retaining sufficient flexibility to react to changing circumstances. However, while family business owners may wish to take advantage of lifetime gifting opportunities, they may have very little idea of their children's eventual interest in the business or their business acumen. Also, many taxpayers are unwilling to make transfers that result in current gift tax because of the uncertainty surrounding the future of federal estate and gift taxes. Despite these uncertainties, there are strategies that can be implemented currently that will provide a framework for both current and future transfers with minimal gift tax exposure.

For example, the majority owner of a successful closely held business may wish to transfer a significant interest in the business to his children at a time when he believes the company is undervalued, but does not want to dilute his voting power relative to the other shareholders. If his children are minors, he will likely want the transferred interests to be held in some type of trust for their benefit. If additional children are born after the transfer, he may wish for those children to share in the transferred interests as well. Like many closely held businesses, the value of his business may be volatile. Finally, while the business owner may wish to transfer shares of the company to his children, he would like to control (to the extent possible) to whom the other owners transfer interests.

Because of these issues, and the uncertainty of the federal estate and gift taxes, the business owner may be uncomfortable making a current transfer to children that will exhaust his or her remaining gift tax exemption or cause him to incur gift tax currently. An integrated business succession plan can address these issues. The plan may include a buy-sell agreement (see §§2.2-2.12), corporate recapitalization or other reorganization (see §§2.13-2.15), lifetime transfer strategies (see §§2.16-2.39), and advance planning for payment of estate taxes (see §§2.40-2.42).

© The Regents of the University of California

§2.2 II. BUY-SELL AGREEMENTS

A buy-sell agreement is an important component of a business succession plan for a closely held business and can be used to control who will be allowed to receive shares in the company. This is typically an important factor for the sole or majority owner of a closely held business. For example, the agreement can provide for a right of first refusal exercisable by the company or the other owners on the occurrence of specified triggering events, such as when an owner wishes to transfer (by gift or sale) some or all of his or her shares. See §2.3.

The agreement could further provide for a mandatory buy-out of a deceased (or retiring) owner's shares. The buy-out allows the other owners to retain ownership of the company following the death (or retirement) of an owner. Methods of funding the buy-out are discussed in §2.4. Providing for a buy-out on the death of an owner provides a market for the deceased owner's interest in the business, providing funds for his or her estate to pay estate taxes or other expenses. If properly structured, the buy-sell agreement can also fix the value of the deceased owner's interest for estate tax purposes. See §§2.5-2.11.

PRACTICE TIP: A mandatory buy-out provision can also address certain of a majority interest holder's concerns about minority owners. For example, for various reasons one or more family members, friends, or business associates may acquire minority interests in a business when it is originally formed, but over time those minority interest holders may become disenchanted with the company's management, earnings and distributions, or general direction. These types of issues can be addressed by including a provision that requires the company to purchase a minority owner's interest for the price set by the agreement at any time determined by the owner. This not only provides liquidity for the minority owners, it also allows them to simply get out of the business if they no longer find it an attractive investment or disagree with management. At the same time, it gives the majority owner the freedom to run the business without interference from disgruntled minority owners.

The buy-sell agreement can also control the ownership of interests in the business in the event of a divorce. Ideally, before a buy-sell agreement is entered into, the character of the business interests subject to the agreement (as separate property, community property, or quasi-community property) would be confirmed in the agreement or transmuted in a separate agreement. However, the character of the interests may not be easily determined, and the parties to the agreement and their advisors may be uncomfortable making or attempting to make this determination. See §2.12. For further discussion of these strategies and sample forms, see Business Buy-Sell Agreements (Cal CEB 1991).

© The Regents of the University of California

§2.3 A. Giving Owner Right of First Refusal

The majority owner of a business will likely want the flexibility to freely transfer interests for estate planning purposes but may be uncomfortable giving this same flexibility to the other business owners (whether or not they are related).

One way to address this issue is to provide in the buy-sell agreement for a sale, gift, or other transfer to trigger a right of first refusal, exercisable by the company or the other owners. This allows the majority owner to cause the company to repurchase any shares that would otherwise be transferred to a new transferee that the majority owner does not want to have involved in the business. At the same time, as long as the majority owner controls the business, the right of first refusal does not inhibit him or her from transferring his or her interest. Other common triggering events include the retirement, disability, bankruptcy, or divorce of an owner.

The right of first refusal could be coupled with a requirement that any transfer be approved by a specified percentage of the owners. If desired, the right of first refusal also can be limited to transfers other than gifts.

© The Regents of the University of California

§2.4 B. Evaluating Methods of Funding Buy-Out

If the buy-sell agreement will include a mandatory buy-out provision, as discussed in §2.2, the method of funding the buy-out should balance the needs of the business and the owners, and may differ depending on the triggering event. For example, there may be less need for immediate liquidity on retirement than on death. An installment note could be used to fund a buy-out on retirement, whereas cash (or a combination of cash and a note) could be used to fund a buy-out on death. One popular method for funding a buy-out on death is life insurance.

Although a detailed discussion of funding a buy-sell agreement with life insurance is beyond the scope of this chapter, there are certain disadvantages of using life insurance to fund a corporate redemption.

- If the corporation is the owner and beneficiary of the policy, the premium payments are not deductible for income tax purposes. IRC §264(a)(1). Further, the receipt of the policy proceeds could trigger the imposition of the corporate alternative minimum tax, although this is not a concern for S corporations. See IRC §§55-59, 1363(a).

- If the buy-sell agreement is not effective to fix the value of the stock for estate tax purposes (see §§2.5-2.11), the stock will be valued at its fair market value. IRC §2031; Reg §20.2031-2(a). In a corporate redemption funded by life insurance, the estate runs the risk that the insurance proceeds received by the corporation will be indirectly included in the estate by increasing the value of the shares for estate tax purposes. See *Estate of George Herbert Atkins* (1943) 2 TC 332. This could result in the estate paying estate tax on a value that is higher than the price it actually received under the buy-sell agreement. See IRC §2703. But see *Estate of Blount v Commissioner* (11th Cir 2005) 428 F3d 1338 (even though buy-sell agreement did not fix estate tax value of corporate stock, value of decedent's stock was not increased by proceeds of corporation-owned life insurance policy on decedent's life that was used to fund redemption of stock). For discussion of the need for caution in applying the decision in *Blount,* see Business Buy-Sell Agreements §2.52 (Cal CEB 1991).

If the corporation chooses to forego insurance and instead to accumulate savings to fund its obligations under a buy-sell agreement, the corporation could be subject to accumulated earnings tax under IRC §531. The accumulated earnings tax applies to accumulations beyond the "reasonable needs of the business." IRC §533. Savings for an IRC §303 redemption in the year of a shareholder's death is considered an accumulation for reasonable business needs, and thus not subject to accumulated earnings tax, but savings accumulated for redemptions triggered by events other than death do not qualify for the §303 exception. IRC §537(a)(2), (b)(1).

© The Regents of the University of California

§2.5 C. Using Agreement to Fix Estate Tax Value

An important estate planning goal of a buy-sell agreement is to fix the price of the business interest for estate tax purposes. As discussed in §2.4, it could be disastrous if the price the deceased owner's estate received under the agreement was less than the value determined for estate tax purposes. Six requirements must be met for a buy-sell agreement to successfully fix the price of the business interests for estate tax purposes under IRC §2703:

- The agreement must constitute a bona fide business arrangement (see §2.6);
- The agreement must not be a device to transfer property to the decedent's family members for less than full and adequate consideration (see §2.7);
- The agreement's terms must be comparable to similar agreements entered into by persons in arm's-length transactions (see §2.8);
- The agreement must restrict the transfer of the business interest to the agreement price both during life and at death (see §2.9);
- The decedent's estate must be obligated to sell the business interest at the price fixed by the agreement (see §2.10); and
- The price must be fixed or calculable according to a formula or other reasonable method specified in the agreement (see §2.11).

The first three requirements are contained in IRC §2703(b) and are amplified in Reg §25.2703-1 (these requirements are stated as an exception to the general rule under IRC §2703(a) that rights or restrictions in buy-sell agreements that affect the value of business interests are ignored for estate tax valuation purposes). The next three are found in Reg §§20.2031-2—20.2031-3.

PRACTICE TIP: These requirements may be more easily satisfied when both family members and nonfamily members are parties to the buy-sell agreement. The rights and restrictions contained in the agreement will be deemed to satisfy the first three requirements if more than 50 percent by value of the interests subject to the rights or restrictions is owned, directly or indirectly, by persons who are not members of the transferor's family. However, the unrelated parties must be subject to the rights or restrictions to the same extent as the transferor. Reg §25.2703-1(b)(3).

For purposes of determining whether this 50-percent test is met, "members of the family" include the persons described in Reg §25.2701-2(b)(5) and "any other individual who is a natural object of the transferor's bounty." Reg §25.2703-1(b)(3).

© The Regents of the University of California

§2.6 1. Bona Fide Business Arrangement

The agreement must constitute a bona fide business arrangement. IRC §2703(b)(1); Reg §25.2703-1(b)(1)(i). For example, providing continuity of management and the preservation of family control should meet this requirement. *Estate of Joyce C. Hall* (1989) 92 TC 312. The business purpose test must be satisfied at the time the agreement is entered into, rather than at the date of the decedent's death. See *St. Louis County Bank v U.S.* (8th Cir 1982) 674 F2d 1207.

© The Regents of the University of California

§2.7 2. Not a Device to Transfer Property to Family Members for Less Than Full and Adequate Consideration

The agreement must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration in money or money's worth. IRC §2703(b)(2); Reg §25.2703-1(b)(1)(ii). Although "members of the decedent's family" are not defined in IRC §2703, the regulations state that "members of the transferor's family" include the persons described in Reg §25.2701-2(b)(5) and "any other individual who is a natural object of the transferor's bounty." Reg §25.2703-1(b)(3). The persons described in Reg §25.2701-2(b)(5) are "applicable family members, and any lineal descendants of the parents of the transferor or the transferor's spouse." According to IRC §2701(e)(2), "applicable family members" are the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor.

NOTE: Nieces and nephews are "members of the transferor's family." Because they are children of an individual's siblings, they are lineal descendants of the parents of the transferor and thus included in the class of people described in Reg §25.2701-2(b)(5). See IRS Letter Ruling 9222043.

The issue of whether a buy-sell agreement is a testamentary device is a factual determination based on the parties' intent at the time they entered into the agreement. Some factors that may cause the IRS to view a buy-sell agreement as a testamentary device are the absence of a periodic price revaluation provision, the arbitrary manner in which the price was selected (including the failure to obtain appraisals or professional advice, overly generous payment terms, the lack of bona fide negotiations in setting the price, a lack of attention to formalities in drafting the agreement, the fact that the decedent had previously reported higher values for gift tax purposes than the price set in the agreement. *Estate of True v Commissioner* (10th Cir 2004) 390 F3d 1210; *Cameron W. Bommer Revocable Trust,* TC Memo 1997-380.

© The Regents of the University of California

§2.8 3. Evidence of Comparable Arm's-Length Transactions

The terms of the agreement must be comparable to similar agreements entered into by persons in arm's-length transactions. IRC §2703(b)(3); Reg §25.2703-1(b)(1)(iii). A right or restriction in the buy-sell agreement will satisfy this requirement if it could have been obtained in a fair bargain among unrelated parties in the same business. To be considered in making this determination are such factors as the expected term of the agreement, the current fair market value of the property, anticipated changes in value during the term of the agreement, and the adequacy of any consideration given in exchange for the rights granted. Reg §25.2703-1(b)(4)(i).

A right or restriction is considered a fair bargain among unrelated parties in the same business if it conforms with the general practice of unrelated parties under negotiated agreements in the same business. Although it is not necessary that the buy-sell agreement parallel the terms of any particular agreement, isolated comparables do not show the requisite general business practice. When several valuation methods are commonly used in a particular business, the buy-sell agreement will not fail this general business practice test merely because it uses only one of those methods. A business may be unique, making it difficult to find comparables. In that case, comparables from similar businesses may be used. Reg §25.2703-1(b)(4)(ii). Also, according to the legislative history of IRC §2703, expert testimony may be used to establish that these requirements have been met. Senate Finance Committee Report, S Rep No. 3209, *Small Business Incentives,* 101st Cong, 2d Sess (1990).

© The Regents of the University of California

§2.9 4. Lifetime Restrictions

The agreement must restrict the transfer of the business interest to the agreement price both during life and at death. Reg §§20.2031-2(h); 20.2031-3. A right of first refusal, exercisable during life, will meet this requirement if the price under the right of first refusal does not exceed the price at death. *Estate of True v Commissioner* (10th Cir 2004) 390 F3d 1210, 1218; *Estate of Gloeckner v Commissioner* (2d Cir 1998) 152 F3d 208.

© The Regents of the University of California

§2.10 5. Obligation of Estate to Sell

The decedent's estate must be obligated to sell the business interest at the price fixed by the agreement. Reg §§20.2031-2—20.2031-3. Either a mandatory buy-out or an option to purchase, combined with the estate's obligation to sell, will meet this requirement because in either case the deceased owner's estate has no choice whether to sell the interest and at what price. *Estate of True v Commissioner* (10th Cir 2004) 390 F3d 1210, 1218; *Estate of Gloeckner v Commissioner* (2d Cir 1998) 152 F3d 208.

© The Regents of the University of California

§2.11 6. Determinable Selling Price

The price must be fixed or calculable according to a formula or other reasonable method specified in the agreement. Reg §§20.2031-2—20.2031-3. If this and the other requirements listed in §§2.6-2.10 are met, the price specified in the buy-sell agreement will be accepted for federal estate tax valuation purposes, even if the price is less than the fair market value of the stock or business interest at the relevant date for fixing that value. When the agreement is a testamentary substitute, however, the price will be disregarded, if it does not "bear a reasonable relationship to the unrestricted fair market value" of the interest. *Estate of Joseph H. Lauder,* TC Memo 1992-736; *Estate of True v Commissioner* (10th Cir 2004) 390 F3d 1210; *Estate of Gloeckner v Commissioner* (2d Cir 1998) 152 F3d 208. See §2.7.

© The Regents of the University of California

§2.12 D. Using Agreement to Allocate Marital Property

The interest of a married owner in a closely held business may be partly separate and partly community property. For example, if Husband had an interest in a business before his marriage to Wife, that interest is clearly his separate property as of the date of the marriage. Fam C §770. However, property derived from the skill, efforts, and industry of spouses generally constitutes community property (in the absence of an agreement to the contrary). Fam C §760. Husband has actively participated in the business as CEO during the entirety of the marriage, and the value of the company has increased during this time. The increase in value during the marriage is attributable partly to capital (which is Husband's separate property) and partly to Husband's efforts and skill (which is community property). In the event of dissolution of the marriage or death of one of the spouses, the increase in value must be allocated between Husband's separate property and the community property of Husband and Wife. This allocation is made not under a formula, but rather is typically made under whichever of two facts-and-circumstances approaches (the "*Perreira* approach" and the "*Van Camp* approach") adopted by California courts is determined to be appropriate to the particular case at issue. *Beam v Bank of America* (1971) 6 C3d 12, 18, 98 CR 137; *Perreira v Perreira* (1909) 156 C 1, 7, 103 P 488; *Van Camp v Van Camp* (1921) 53 CA 17, 29, 199 P 885. See Practice Under the California Family Code: Dissolution, Legal Separation, Nullity §5.16 (Cal CEB Annual).

One way of dealing with this uncertainty surrounding the character of a business interest owned by a married person is for both spouses to be parties to the agreement and to provide that dissolution triggers a buy-out of the community property interest (if any) of the spouse who is not active in the business at the price set by the agreement. Alternatively, the agreement could specify that, in the event of dissolution, the couple's entire community property interest is allocated to the spouse who is active in the business, and other assets of an equal value are allocated to the nonactive spouse (valued by the price set by the agreement).

Under either of these options, the company will avoid becoming involved in the dissolution proceeding and being forced to deal with the nonactive spouse, and there will be a predetermined method for determining the value of the nonactive spouse's interest. Likewise, the nonactive spouse will not be forced to be involved in the business of his or her ex-spouse and can receive a potentially more liquid asset (*e.g.,* cash or a promissory note under a buy-out provision or some other asset owned by the couple) rather than an illiquid business interest.

However, attempting to make any sort of allocation between separate and community property when entering into a buy-sell agreement is not only complicated, but will likely require separate legal representation for each spouse. Many clients are unwilling to enter into negotiations with their spouses concerning their marital property rights when entering into a buy-sell agreement. In addition, there are estate tax implications when making a definitive characterization or effecting a transmutation—community property assets receive a step-up in basis under IRC §1014, while separate property assets of the surviving spouse do not.

© The Regents of the University of California

§2.13 III. CORPORATE RECAPITALIZATION

As discussed in §§2.2-2.12, a buy-sell agreement is an important component of the overall succession plan for a closely held business owner. A majority owner can transfer shares to his or her descendants or other beneficiaries without the need for the approval of the other owners, and at the same time approve or veto transfers by the other owners. Although a majority owner may want to transfer a significant portion of the value of his or her shares to his or her descendants, the owner may not want to dilute his or her voting power relative to the other owners. The restructuring of a corporation to create two classes of stock, voting and nonvoting, can achieve these two goals. The owner can retain the voting shares, and make gifts of the nonvoting shares. In that way, he or she can transfer value to his or her descendants while retaining control of the company. The two-step process is described in §§2.14-2.15.

Neither the recapitalization creating voting common and nonvoting common stock nor the subsequent gifts of the nonvoting common stock are subject to IRC §2701. See, *e.g.,* IRS Letter Ruling 9414012. Thus, the value of any gifts is determined under traditional valuation principles instead of the generally unfavorable subtraction method under IRC §2701. Nor should the recapitalization constitute a lapse of a voting right under IRC §2704. Finally, the creation of the voting and nonvoting common stock does not run afoul of the S corporation rules. Although an S corporation may have only one class of stock (IRC §1361(b)(1)(D)), differences relating solely to voting rights will not violate the single class of stock requirement (IRC §1361(c)(4)).

© The Regents of the University of California

§2.14 A. Step One: Amending Articles of Incorporation

The restructuring is accomplished by first amending the company's articles of incorporation to authorize the issuance of both voting and nonvoting common stock (*e.g.,* three shares of nonvoting common stock for every one share of voting common stock), and then transferring the nonvoting common stock (see §2.15).

The two classes of stock are identical except for the voting rights. On the filing of the amended articles, all outstanding shares of the company's common stock is reclassified as voting common stock. The company's board of directors can declare a dividend of three shares of nonvoting common stock for each share of voting common stock outstanding. Thus, the proportionate voting power among the shareholders remains the same following the stock dividend.

© The Regents of the University of California

§2.15 B. Step Two: Transferring Nonvoting Common Stock

Having amended the articles of organization to authorize issuance of nonvoting common stock (see §2.14), the majority shareholder can then transfer some or all of his or her nonvoting common stock of the company, which will allow the shareholder to shift the economic benefit of the shares to his or her descendants without affecting his or her voting control. The value of the transferred stock is frozen for gift and estate tax purposes, and none of the income and appreciation attributable to the transferred stock will be included in the transferring shareholder's estate for estate tax purposes. Two techniques to effect a transfer of the nonvoting stock are a gift to a grantor retained annuity trust (GRAT) and an installment sale to a grantor trust. See §§2.16-2.30.

© The Regents of the University of California

§2.16 IV. LIFETIME TRANSFER STRATEGIES

Although an owner of a closely held business may want to transfer economic benefit to his or her descendants, he or she will likely want to do so in a manner that will result in no current gift tax cost and use as little of his or her remaining lifetime gift tax exemption as possible, because of uncertainty surrounding the future of federal estate and gift taxes. The owner could simply make a gift of an interest in the business, but that gift would result in a taxable gift to the extent that its value exceeds the donor's IRC §2503(e) gift tax annual exclusion, and the gift would result in a gift tax to the extent that the value of the gift exceeds the owner's unused IRC §2505 gift tax applicable exclusion amount ($1 million minus previous taxable gifts).

Two viable techniques that should result in little or no gift tax, both of which are appropriate for the transfer of a closely held business interest, are:

- A gift to a grantor retained annuity trust (GRAT) (see §§2.17-2.24) and
- An installment sale to a grantor trust (see §§2.25-2.30).

Because the risks and benefits of each of these techniques are somewhat different, they can successfully be used in conjunction with one another to transfer assets to younger generations with little or no tax cost. However, special care must be taken in the transfer of interests in an S corporation to a trust. See §§2.31-2.38. In either a gift or a sale transaction, the business interest transferred must be properly valued for gift tax purposes. See §2.39.

© The Regents of the University of California

§2.17 A. Grantor Retained Annuity Trust (GRAT)

A GRAT is an irrevocable trust in which the grantor retains a right to annual payments of a fixed amount (which may be expressed as a fixed fraction or percentage of the initial fair market value of the property transferred to the trust as finally determined for federal tax purposes) for a fixed term (*e.g.,* for a specified term of years), and other noncharitable beneficiaries (*e.g.,* the grantor's children) have the right to receive, either outright or in further trust, the property remaining in the GRAT at the end of the term. Any shares remaining in the GRAT at the end of its term can be held in a further trust for the benefit of the GRAT remainder beneficiaries.

Basic tax considerations in using GRATs are discussed in §§2.18-2.22. "Zeroed-out" GRATs are discussed in §2.23. Practical considerations in using GRATs are discussed in §2.24. For a detailed discussion of GRATs, see Drafting California Irrevocable Trusts, chap 15 (3d ed Cal CEB 1997).

© The Regents of the University of California

§2.18 1. GRAT Basics

In general, if a grantor makes a transfer in trust for the benefit of a member of his or her family and retains an interest in the trust, the grantor's retained interest is valued at zero for gift tax purposes, and gift tax is incurred on the full fair market value of the property transferred to the trust. IRC §2702. However, if the grantor's retained interest is a "qualified interest" under §2702, it will be valued under IRC §7520 and subtracted from the full fair market value of the property transferred to the trust in determining the value of the gift. IRC §2702(a)(2). A retained interest in a grantor retained annuity trust ("GRAT") is one such qualified interest under §2702. The annuity amount can be structured so that it increases during the term by up to 120 percent of the annuity amount paid for the preceding year.

© The Regents of the University of California

§2.19 a. Gift Tax Considerations in Using GRATs

The identity of the persons and/or trusts who will receive the remainder interest in the trust is beyond the control of the grantor after the trust has been created and, therefore, the creation of the GRAT results in an immediate taxable gift of the remainder interest in the GRAT. The value of the remainder interest in the GRAT for gift tax purposes is determined by subtracting the actuarial present value of the grantor's retained interest, as determined under valuation tables prepared and published monthly by the Treasury, from the gift tax value of all property transferred to the trust. The primary estate planning objective is to have the remainder interest undervalued for gift tax purposes. This requires that the assets in the trust grow at a rate greater than the annual rate reflected in the Treasury's valuation tables. GRATs are an attractive gifting option when the prescribed interest rate is low.

© The Regents of the University of California

§2.20 b. Estate Tax Considerations in Using GRATs

Because all property in the GRAT may be subject to estate tax in the grantor's estate if the grantor dies before the end of the term, the term of the GRAT should be set to expire well within the grantor's life expectancy.

If the business interest transferred to the GRAT meets the definition of a controlled corporation under IRC §2036(b)(2), the transferor should not act as the trustee of the trust for the GRAT remainder beneficiaries to prevent inclusion of the trust assets in his or her estate for estate tax purposes under §2036(b).

© The Regents of the University of California

§2.21 c. GRAT Treated as Grantor Trust

If the GRAT is treated as a wholly owned grantor trust for income tax purposes, *e.g.,* under IRC §673 or §677(a), all income of the GRAT is taxed to the grantor. Under current law, the grantor's payment of the GRAT's income taxes is not an additional gift to the GRAT for transfer tax purposes. See Rev Rul 2004-64, 2004-2 Cum Bull 7. This improves the economics of the GRAT because the remainder interest is not reduced by the trust's income taxes.

© The Regents of the University of California

§2.22 d. GST Tax Considerations in Using GRATs

Although a GRAT can be a very attractive method for making a gift, it is generally not an effective mechanism to reduce generation-skipping transfer (GST) tax, because the transferor's GST exemption cannot be allocated under IRC §2642 until the end of the GRAT term, using the fair market value of the trust property at that time.

© The Regents of the University of California

§2.23 2. Zeroed-Out GRATs (*Walton* GRATs)

Under the Tax Court's decision in *Audrey J. Walton* (2000) 115 TC 589, acq 2003-2 Cum Bull 964, it is possible to structure a transfer to a GRAT so that the actuarial present value of the grantor's retained interest is equal to the gift tax value of all property transferred to the trust. This reduces the value of the taxable gift to zero so that no gift tax is paid in connection with the transaction. Before *Walton,* the IRS took the position that the value of the gift could never be reduced to zero. Relying on Reg §25.2702-3(e), Example 5, the IRS maintained that, in determining the value of the grantor's retained interest for gift tax purposes, the possibility that the trust property will revert to the grantor's estate if he or she dies before the term of the trust expires must be taken into account (even when the grantor retains the right to the annuity for a fixed term of years). Under this view, the value of the grantor's retained interest cannot be equal to the value of all the property transferred to the trust, because the risk that the grantor could die within the term of the trust will always have some value.

The Tax Court rejected the IRS position in *Walton*. In that case, the grantor created two substantially identical GRATs, each with a 2-year term. If the grantor died within the term, the remaining annuity payments would be paid to her estate. The court held that the regulation was invalid and concluded that there was no basis for the IRS position that the payment to the grantor's estate should be ignored in determining the value of the grantor's retained interest. Whether or not the grantor died within the 2-year term, all of the annuity payments would be made (either to the grantor or to her estate). In Notice 2003-72, 2003-2 Cum Bull 964, the IRS conceded that the Tax Court was correct and stated that the regulation will be revised to treat the payments to the grantor's estate as part of the qualified interest.

© The Regents of the University of California

§2.24 3. Practical Considerations in Using GRATs

A GRAT is a particularly useful gifting technique for an asset that is substantially undervalued for gift tax purposes in light of its future total return potential, such as a closely held family business interest that receives large valuation discounts for lack of marketability and minority interest. The earnings on such an asset, as a percentage of its gift tax value, are often well in excess of the rate prescribed in IRC §7520.

In addition, a transfer to a GRAT may be timed to coincide with a low valuation of the transferred property (*e.g.*, due to market fluctuations or before an anticipated liquidity event), thereby "freezing" the value of the transferred property at that lower value for transfer tax purposes.

Because a zeroed-out GRAT can effect a transfer of assets with no gift tax cost (see §2.23), it is also a particularly useful technique for a closely held business interest, the value of which may be uncertain or volatile. If the value of the transferred interest declines following the gift, the transferor will not have wasted any of his or her gift tax exemption or incurred out-of-pocket gift tax cost.

If the business makes cash distributions, the cash received by the GRAT can be used to pay some or all of the annuity amount. Alternatively, the annuity amount can be paid by distributing interests in the business, although this would require that those interests be valued as of the date the annuity payment is made.

Although the trustee of the GRAT can borrow funds and use those funds to make the annuity payments, the GRAT cannot issue a note or other debt instrument in satisfaction of the annuity amount. Reg §25.2702-3(d)(6). If the GRAT receives an infusion of cash during its term from a liquidity event, that cash can be used to make the annuity payments. The timing of the anticipated liquidity event should be considered in setting the term for the GRAT.

© The Regents of the University of California

§2.25 B. Installment Sale to Grantor Trust

A business owner can transfer economic value to his or her descendants by selling interests in the business to the descendants (or one or more trusts for their benefit) in exchange for an installment note. The transfer can be further leveraged by selling the interests to a generation-skipping trust for the benefit of the descendants. The sale can be structured so there are no income tax consequences, if the trust is structured as a grantor trust for federal income tax purposes. See §§2.26-2.30.

For further discussion of this planning strategy, see Drafting California Irrevocable Trusts §§3.44B-3.44C (3d ed Cal CEB 1997).

© The Regents of the University of California

§2.26 1. Basic Grantor Trust Strategy

A grantor trust is a trust that contains certain powers (described in IRC §§671-679) that cause either the person who created the trust (the grantor) or a beneficiary of the trust to be treated as the owner of all or a portion of the trust for income tax purposes. If the trust is structured so that the seller/business owner is treated as owning the entire trust under the grantor trust rules, the sale to the trust is disregarded for income tax purposes. Accordingly, the seller does not pay income tax on the installment payments he or she receives. The note can be structured as an interest-only note, with a balloon payment at the end of the note term. The note should bear interest at a rate at least equal to the applicable federal rate under IRC §7520 to ensure that the transaction will not be treated as a gift loan under IRC §7872 and should specify that there is no penalty for prepayment.

The effect of the sale is to shift any appreciation in excess of the installment and balloon payments to the trust so that it can achieve results that are similar to transferring assets to a GRAT. Unlike a gift to a GRAT, the sale is not a gift for gift tax purposes, so it does not need to be reported on a gift tax return, and the assets sold are removed from the seller's estate even if he or she dies before the note is paid off. If the sale is disclosed on a gift tax return in a manner that satisfies the adequate disclosure requirements of IRC §6501(c)(9) and regulations thereunder, however, the 3-year statue of limitations will begin to run and the IRS cannot challenge the transaction (including the valuation of the business interest) if it does not do so within 3 years.

© The Regents of the University of California

§2.27 a. Income Tax Considerations in Sale to Grantor Trust

Because the seller is treated as the trust's owner for income tax purposes, the income tax imposed on the trust's income will be borne by the seller rather than by the trust. Under current law, paying the trust's income taxes is not an additional gift by the seller for federal gift tax purposes, and it allows the trust property to accumulate tax-free for the beneficiaries. See Rev Rul 2004-64, 2004-2 Cum Bull 7. However, income tax may be imposed if the seller dies during the term of the note, so this risk should be considered when setting the term of the note. If, at some point in the future, the seller no longer wishes to pay the trust's income taxes (*e.g.*, if the business is sold, and the sale will produce a significant gain for the trust), the grantor trust power can simply be irrevocably released. Following the release, the trust will no longer be a grantor trust and will thereafter pay its own income taxes.

© The Regents of the University of California

§2.28 b. Gift Tax Considerations in Sale to Grantor Trust

If properly structured, the sale should produce little or no gift tax. The trust should acquire other assets before the sale of the business interest, typically with a value of at least 10 percent of the purchase price of the property to be purchased, to establish that the trust is creditworthy and to ensure that the entire transaction will not be treated as lacking economic substance. It is important to carefully determine the price paid for the asset (*e.g.,* by appraisal for a sale of a business interest), because if the price paid for the assets is less than fair market value, gift tax could be imposed.

If the trust does not have sufficient other assets, the seller can make a gift of this "seed money" to the trust, in the form of cash or other assets. Cash is an appropriate asset to use for this purpose. It is easily valued for gift tax purposes (although valuation discounts are not available), and it can provide a payment source for at least some of the interest payments on the installment note. This is particularly useful if the trust does not receive sufficient income (*e.g.,* from dividends or other distributions from the company) to cover the interest payments.

Another alternative would be to use interests in the business to make the interest payments, but this requires those interests to be valued each time an interest payment is made, which adds to the overall cost of the transaction. Also, the seller's goal is to transfer interests in the business out of his or her estate rather than move them back into the estate, particularly if it is anticipated that the value of the business will increase after the sale. Another alternative is to borrow money from a bank or other third party, but again this increases the overall cost and complexity of the transfer.

Because the sale is not subject to federal gift tax, none of the seller's IRC §2631 generation-skipping transfer (GST) tax exemption need be applied to the transfer. However, if the trust is designed to be a generation-skipping trust, the donor's GST exemption should be applied to the gift of the seed money in order to maintain an inclusion ratio of zero for the trust. Although the IRC §2503(b) gift tax annual exclusion can be used to shelter gifts of seed money to the trust for gift tax purposes, annual exclusion gifts to a generation-skipping trust are not exempt from GST tax if the trust has more than one beneficiary. IRC §2642(c).

© The Regents of the University of California

§2.29 2. Comparison of Sale to Grantor Trust With GRAT

The sale technique may be preferable to a GRAT when the timing of the asset's appreciation is uncertain because the trust can make interest-only payments during the term of the note, with a balloon payment due at the end of the term. If the value of the assets fluctuates during the term of the note or increases later during the term, the overall performance may be affected less with a sale than with a GRAT. If the seller anticipates that he or she will sell some or all of the business interests in the near term, the sale proceeds received by the trust can be used to pay the note.

However, the sale technique may be perceived as more aggressive for tax purposes than a GRAT because, unlike a GRAT, there is no statutory authority for a sale to a grantor trust. Further, structuring this type of sale may be more complicated than making a gift to a GRAT. For example, the seller may need to make a gift of seed money to the trust if it does not have sufficient other assets before the sale. See §2.28.

© The Regents of the University of California

§2.30 3. Combining Sale to Grantor Trust With GRAT

It may be advisable to utilize both one or more GRATs and a sale to a grantor trust in order to capture the benefits (and reduce the risks) associated with both techniques.

The business owner can serve as the trustee of the trust that is the remainder beneficiary of a GRAT or that purchases interests in the business from the owner as long as the business is not a controlled corporation under IRC §2036(b) and the owner does not have any powers as trustee that would cause the trust assets to be included in his or her estate under IRC §2036(a).

© The Regents of the University of California

§2.31 C. Transfer of S Corporation Interests to Trust

Special care must be taken when transferring interests in an S corporation to a trust because only certain types of trusts are qualified S corporation shareholders. The consequence of a shareholder failing to be a qualified S corporation shareholder is the loss of the corporation's status as an S corporation. A trust is eligible to hold S corporation stock if it is one of the following (IRC §1361(c)(2)(A)):

- A "grantor trust" under the provisions of IRC §§671-679, if the deemed owner under the grantor trust rules is a U.S. citizen or resident (see §2.32);
- A qualified subchapter S trust (QSST) (see §§2.33-2.35); or
- An electing small business trust (ESBT) (see §§2.36-2.38).

© The Regents of the University of California

§2.32 1. Grantor Trust as S Corporation Shareholder

A grantor trust is a trust that contains certain powers (described in IRC §§671-679) that cause it to be deemed to be owned for federal income tax purposes either by the person who created the trust (the "grantor") or by a beneficiary of the trust. In either case, as long as the deemed owner is a U.S. citizen or resident, it is qualified to hold S corporation stock. IRC §1361(c)(2)(A)(i).

For purposes of determining whether an S corporation has met the requirement that it have no more than 100 shareholders (IRC §1361(b)(1)(a)), the deemed owner of a grantor trust (rather than the trust itself) is treated as the shareholder. IRC §1361(c)(2)(B)(i). If a trust ceases to be a grantor trust because of the death of the deemed owner, the trust will continue to be treated as a qualified S corporation shareholder for a period of two years. IRC §1361(c)(2)(A)(ii). On the other hand, if the trust's status as a grantor trust ceases because the powers that caused it to be treated as a grantor trust are relinquished, the trust will immediately cease to be a qualified S corporation shareholder.

© The Regents of the University of California

§2.33 2. Qualified Subchapter S Trust (QSST)

A qualified subchapter S trust ("QSST") is a special form of trust that is treated as an eligible S corporation shareholder. IRC §1361(d)(1)(A). By definition, a QSST is a trust the terms of which require that (IRC §1361(d)(3)(A)):

- During the lifetime of the current income beneficiary, there can be only one income beneficiary;
- Distributions of principal during the current income beneficiary's lifetime can be made only to that beneficiary;
- The current income beneficiary's income interest must terminate at the earlier of the current income beneficiary's death or the termination of the trust; and
- If the trust terminates during the current income beneficiary's lifetime, all trust assets must be distributed to the current income beneficiary.

The income of the trust must be distributed at least annually, and the trust will be treated as a grantor trust. See §§2.34-2.35.

For a trust to be treated as a QSST, the trust's current income beneficiary must make an election ("QSST election"), which is filed with the IRS. The QSST election must be timely made to be effective and, once made, the election is revocable only with the consent of the IRS. IRC §1361(d)(2); Reg §1.1361-1(j)(11). The election must be made within 2 months and 16 days after the stock is transferred to the trust. Reg §1.1361-1(j)(6)(iii). If the election is being revoked because the trust wishes to convert to an electing small business trust (ESBT), the IRS will automatically consent as long as certain conditions are met. Reg §1.1361-1(j)(12).

A trust that has multiple beneficiaries can meet the QSST single-beneficiary requirement if each beneficiary has a separate and independent share of the trust within the meaning of IRC §663(c), each of which is treated as a separate trust for federal income tax purposes. IRC §1361(d)(3).

© The Regents of the University of California

§2.34 a. Income Distribution Requirement for QSST

In addition to the requirements in §2.33, all the trust's accounting income must either be required by the trust instrument to be distributed, or actually be distributed, to the income beneficiary at least annually. The income must be distributed directly to the beneficiary or to a custodial account for the benefit of a minor beneficiary. The income cannot be distributed to a trust for the benefit of the beneficiary. IRC §1361(d)(3)(B). (In a private letter ruling, the IRS created a limited exception to this rule, allowing income from a QSST to be paid to the beneficiary or returned to the trust at the discretion of a conservator, custodian, or guardian for the beneficiary when the beneficiary is under a legal disability. See IRS Letter Ruling 9140055.)

© The Regents of the University of California

§2.35 b. QSST Treated as Grantor Trust

A QSST is treated as a grantor trust under IRC §678(a) and is deemed to be owned by the current income beneficiary. IRC §1361(d)(1)(B). As with other grantor trusts, the deemed owner (rather than the trust itself) is treated as the S corporation shareholder. Reg §1.1361-1(j)(*7*)(i). Also, as with other grantor trusts (see §2.32), if a QSST terminates at the deemed owner's death, the trust will have a two-year grace period to transfer the S corporation stock to another eligible S corporation shareholder. Reg §1.1361-1(j)(*7*)(ii).

© The Regents of the University of California

§2.36 3. Electing Small Business Trust (ESBT)

An electing small business trust (ESBT) is another form of trust that is treated as an eligible S corporation shareholder. IRC §1361(c)(2)(A)(v). The requirements for an ESBT are not as restrictive as those for a QSST, described in §§2.33-2.35. For example, an ESBT can have multiple beneficiaries, and the trust income can be accumulated and sprinkled among the multiple beneficiaries. However, an ESBT may be less desirable than a QSST because ESBTs are taxed under special rules that treat the S corporation stock as being held by a separate trust, and tax the income from this separate trust at a flat rate that is equal to the highest rate applicable to trusts and estates rather than the tax rate applicable to the beneficiaries. IRC §641(c).

A trust is eligible to be an ESBT if all of the following requirements are met (IRC §1361(e)(1)(A)):

- No interest in the trust was acquired by purchase;
- All of the trust beneficiaries are individuals, estates, or certain types of charitable organizations; and
- An ESBT election is made by the trustee of the trust. See §2.37. In addition, because each potential current beneficiary of the ESBT is treated as a shareholder of the S corporation (Treas Reg §1.1361-1(h)(3)(i)(F), (m)(4)), each individual must consent to the election to treat the corporation as an S corporation. IRC §1362(a)(2); Treas Reg §1.1362-6(b)(2)(iv). Failure to have all persons who are shareholders of the S corporation (in this case, all potential current beneficiaries of the ESBT) consent to the election invalidates the election. The IRS has authority, however, to waive the inadvertent invalidity of a qualified S corporation election. See IRC §1362(f)(1)(A). Relief from late elections may be requested under Rev Proc 2003-43, 2003-1 Cum Bull 998.

Trusts that have a QSST election in effect, trusts that are exempt from income tax, and charitable remainder trusts are not eligible to be ESBTs. IRC §1361(e)(1)(B).

NOTE: A potential current beneficiary is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the trust. IRC §1361(e)(2). If the ESBT is also a grantor trust, the deemed owner under the grantor trust rules is also treated as a potential current beneficiary. Reg §1.1361-1(m)(4)(ii).

If the trust disposes of all its S corporation stock, any person who met the definition of a potential current beneficiary during the 1-year period ending on the date of disposition is not a potential current beneficiary. Reg §1.1361-1(m)(4)(iii). If the trust does not dispose of the stock within this window, the corporation's status as an S corporation will terminate. Reg §1.1361-1(m)(5). On termination of ESBT, see §2.38.

© The Regents of the University of California

§2.37 a. ESBT Election

An ESBT election is made by the trustee of the trust, and applies to the taxable year for which the election is made and all subsequent years unless it is revoked with the consent of the IRS. IRC §1361(e)(3); Reg §1.1361-1(m)(6). If the election is being revoked because the trust wishes to convert to a QSST, however, the IRS will automatically consent if certain requirements are met. Reg §1.1361-1(m)(7). The ESBT election must be filed within the time requirements prescribed for QSST elections. Reg §1.1361-1(m)(2)(iii).

© The Regents of the University of California

§2.38 b. Termination of ESBT

On the termination of an ESBT, the S corporation stock must be immediately transferred to another qualified S corporation shareholder. If the stock is transferred to a trust that is qualified to be a QSST, the trust's beneficiary must make a timely QSST election (within 2 months and 16 days after the trust becomes a shareholder) or the corporation's S status will terminate. See §2.33. If the stock is transferred to a grantor trust, no election is necessary. See §2.32.

© The Regents of the University of California

§2.39 D. Valuation of Gifts for Federal Gift Tax Purposes

It is important that the business interests transferred, either in a gift or sale transaction, be properly valued for federal gift tax purposes. The value of an interest in a closely held business should generally be determined by a qualified appraiser, although in certain circumstances recent arm's-length sales may provide a reasonable basis for valuing the interest without a complete appraisal.

If the business is subject to a buy-sell agreement, the terms of that agreement should be reviewed in determining the value of a transferred interest in the business. See §§2.2-2.12. However, lifetime transfer restrictions in a buy-sell agreement generally will not fix the value for gift tax purposes. For example, if a lifetime gift triggers a right of first refusal exercisable by the other business owners, the price at which the right may be exercised does not fix the value for gift tax purposes. Rev Rul 59-60, 1959-1 Cum Bull 237. However, restrictions in the agreement are a factor to be considered in determining the fair market value for gift tax purposes. *Charles W. Ward* (1986) 87 TC 78, 104 (although right of first refusal was a factor to be considered in determining gift tax value of transferred interest, it decreased value "only minimally"); *Estate of Pearl Gibbons Reynolds* (1970) 55 TC 172, acq 1971-2 Cum Bull 3 (right of first offer was factor to be considered along with all other relevant factors). See generally Business Buy-Sell Agreements §2.34, chap 5 (Cal CEB 1991). See also chap 1.

© The Regents of the University of California

§2.40 V. PAYMENT OF ESTATE TAXES

The estate of a deceased owner of all or a substantial portion of a closely held business must deal with the illiquidity of an asset for which there is no ready market, as well as the valuation of that asset for federal estate tax purposes. As discussed in §§2.2-2.12, a properly structured buy-sell agreement can address these issues—at least in part—by providing a ready market for the business interest, and perhaps fixing the value for estate tax purposes.

In addition, IRC §§303 and 6166 are designed to aid estates of closely held business owners in providing for the payment of federal estate taxes:

- Section 303 permits the income-tax free withdrawal of funds from a corporation to pay federal and state death taxes. To obtain liquidity, an estate may need to redeem stock of a closely held business included in the estate if deferring payments under IRC §6166 is not available or is undesirable. See §2.41.

- Section 6166 provides an extension of time in which to pay estate taxes attributable to an interest in a closely held business. Unlike IRC §303 redemptions, §6166 relief is available to partnerships and sole proprietorships as well as corporations. See §2.42.

© The Regents of the University of California

§2.41 A. IRC §303 Redemption

Under IRC §303, a distribution made in redemption of stock, to the extent necessary to pay estate, inheritance, legacy, and succession taxes, and funeral and administrative expenses, will be treated as a payment in exchange for the stock, rather than as a dividend. This treatment results in the distribution being treated more favorably as a capital gain only to the extent that the purchase price exceeds the value of the stock for estate tax purposes (which is used to determine the basis of the stock under IRC §1014 and which will be the same as the purchase price if the redemption agreement is used to determine the value of the stock), rather than as a dividend to the extent of the shareholder's prorata share of earnings and profits. IRC §§301, 303(a).

To be eligible for this treatment, the value of all corporate stock that is included in the estate must exceed 35 percent of the value of the decedent's gross estate. IRC §303(b)(2)(A). To meet the 35-percent test, stock of two or more corporations is treated as the stock of one corporation if at least 20 percent of the outstanding stock of each corporation is included in the gross estate. IRC §303(b)(2)(B). For further discussion of §303 redemptions, see §§3.105-3.118.

© The Regents of the University of California

§2.42 B. IRC §6166 Estate Tax Deferral

Internal Revenue Code §6166 allows for deferral of the portion of the estate tax attributable to a decedent's "closely held business interest." An interest in a closely held business is defined as (IRC §6166(b)(1)):

- An interest as a proprietor in a trade or business carried on as a proprietorship;
- An interest as a partner in a partnership carrying on a trade or business if (1) 20 percent or more of the total capital interest in the partnership is included in the decedent's gross estate, or (2) the partnership has 45 or fewer partners; or
- Stock in a corporation carrying on a trade or business if (1) 20 percent or more in value of the voting stock is included in the decedent's gross estate, or (2) the corporation has 45 or fewer shareholders.

Estate tax deferral is available only if the value of the closely held business interest exceeds 35 percent of the decedent's adjusted gross estate. IRC §6166(a).

If requirements for deferral are met, the maximum period of deferral is generally 14 years and nine months after the decedent's date of death, with interest paid only during the first four years. IRC §6166(a).

The interest rate on the deferred tax attributable to the first $1 million (plus cost-of-living adjustments) in value of closely held business interests in excess of the IRC §2010 applicable exclusion amount is 2 percent. IRC §6601(j). The interest rate on the remainder of the deferred tax is 45 percent of the federal underpayment rate under IRC §6621. IRC §6601(j). For further discussion of IRC §6166, see §§3.80-3.104.

© The Regents of the University of California

3

Estate Planning for Vineyards, Farms, and Ranches

Harry B. Maring

I. OVERVIEW §3.1

A. Preliminary Considerations §3.1A

B. Nontax Considerations §3.2

1. Business Plan Along With Estate Plan §3.3

2. Management and Control Issues §3.4

3. Durable Powers of Attorney §3.5

4. Liquidity Issues §3.6

C. Tax Considerations §3.7

1. Farming Operation Discontinued §3.8

2. Farming Operation Continued §3.9

3. Married Couple: Consider Paying Tax on First Death §3.10

4. Lifetime Gifting Program §3.11

a. Practical Problems of Lifetime Gifts of Farm Assets §3.12

b. Use of Trusts, Family Corporations, and Family Partnerships §3.13

c. Areas of Concern in Lifetime Gifts §3.14

5. Buy-Sell Agreements

a. Use of Buy-Sell Agreements §3.15

b. Disadvantages of Buy-Sell Agreements §3.16

II. SPECIAL USE VALUATION UNDER IRC §2032A §3.17

A. Historical Context §3.18

B. General Principal §3.19

C. Requirements for IRC §2032A Special Use Valuation §3.20

D. Member of Family §3.21

E. Qualified Use

1. Definition of Qualified Use §3.22

2. Definition of Farm §3.23

3. Qualified Use and Leases §3.24

4. At-Risk Requirement §3.25

F. Acquisition From or Passing From Decedent to Qualified Heir

1. Acquisition From Decedent §3.26

2. Passing to Qualified Heir §3.27

3. Avoiding Successive Interest Problems §3.28

4. Powers of Appointment §3.29

G. Percentage Tests and Adjusted Value §3.30

1. Determination of Adjusted Value §3.31

2. Discount Planning §3.32

3. Three-Year Inclusion Rule Under IRC §2035 in Relation to Percentage Tests §3.33

4. Determination of Special Use Value §3.34

a. Farm Method or Capitalization of Rents Method

(1) Formula §3.35

(2) Comparable Real Property Defined §3.36

b. Five-Factor Method §3.37

H. Duration of Qualified Use: Five Out of Eight Years §3.38

I. Material Participation §3.39

1. Active Management Rule for Surviving Spouse §3.40

2. Elements of Material Participation §3.41

3. Rental Arrangement and Material Participation: Includable Farm Rental Income §3.42

a. Crop Share Versus Cash Rent §3.43

b. Farmer's Tax Guide (IRS Publication 225) as Guidelines §3.44

4. Use of Agent §3.45

5. Material Participation and Ownership by Entity §3.46

a. Partnership or Corporation §3.47

b. Trust §3.48

c. Estate §3.49

J. The Election

1. Filing Election §3.50

2. Content of Notice of Election §3.51

3. Partial Election §3.52

4. Protective Election §3.53

K. Recapture §3.54

1. Recapture Agreement §3.55

2. Ten-Year Qualified Use Period §3.56

3. Amount of Recapture §3.57

4. Grounds for Recapture of Tax §3.58

a. Disposition of Qualified Interest §3.59

b. Cessation of Qualified Use §3.60

5. Liability for Recapture Tax §3.61

L. Lien for Taxes §3.62

M. Miscellaneous Tax Considerations

1. Basis of Farm Property Passing From Decedent for Income Tax Purposes (IRC §1014) §3.63

2. Basis for Income Tax When Farm Property Sold (IRC §1040) §3.64

3. Holding Period for Capital Gain Purposes §3.65

4. When Considering Sale of Residence §3.66

5. Election for Basis Increase If Recapture Tax Imposed §3.67

6. Generation-Skipping Tax §3.68

7. Proration of Estate Taxes Under Prob C §20114 §3.69

N. Marital Deduction Planning §3.70

1. Funding the Marital Share §3.71

2. Funding the Bypass §3.72

O. Pros and Cons of Using IRC §2032A Special Use Valuation §3.73

III. INCOME IN RESPECT OF DECEDENT (IRD) §3.74

A. Items of IRD for Farmer Under Different Lease Agreements §3.75

B. Transfer of Item of IRD §3.76

C. Holding Period of Farm Assets for Capital Gains Purposes §3.77

1. Definition of Livestock §3.78

2. Race Horses §3.79

IV. INSTALLMENT PAYMENT OF ESTATE TAXES (IRC §6166)

A. 14-Year Deferral §3.80

B. Calculation of 2-Percent Interest Rate §3.81

C. Interest in Closely Held Business §3.82

1. Active Trade or Business §3.83

2. Factors in Determining Whether Interest Is Active Trade or Business §3.83A

3. Impact of Revenue Ruling 2006-34 on Farms §3.84

4. Counting Partners and Shareholders; Family Attribution and Other Special Rules §3.85

5. Adding Up Interests in Two or More Closely Held Businesses

a. Adding 20-Percent Interests §3.86

b. Family Attribution for 20-Percent Test §3.87

6. Holding Companies §3.88

D. Limitation on Tax Amount Payable in Installments §3.89

E. Timing of Payment of Installments §3.90

F. Filing Election §3.91

1. Protective Election §3.92

2. Election After Deficiency Assessed §3.93

G. Disposition of Interest in Closely Held Business; Acceleration of Tax Due §3.94

1. Exceptions to Acceleration Rule: IRC §303 Redemption; Reorganization, and Disposition on Death §3.95

2. Holding Company Disposition §3.96

H. Undistributed Net Income of Estate §3.97

I. Failure to Make Payment of Principal or Interest §3.98

J. Additional Lien Under IRC §6324A §3.99

K. Generation-Skipping Tax §3.100

L. Acceleration Under IRC §6166 and Its Impact on IRC §2032A §3.101

M. Three-Year Inclusion Rule Under IRC §§2035 and 6166 §3.102

N. Other Estate Tax Considerations (QDOT, QTIP, Gift Tax) §3.103

O. S Corporation Stock §3.104

V. IRC §303 REDEMPTIONS TO PAY DEATH TAXES AND ADMINISTRATION EXPENSES

A. Use for Farming Corporation Stock §3.105

B. Aggregating Stock to Meet 35-Percent Test §3.106

C. Use of IRC §303 §3.107

D. Relationship of Shareholder to Estate Tax §3.108

E. Time Frame Covered by Redemption §3.109

F. Property Subject to Redemption §3.110

1. Property Defined §3.111

2. Redemption of IRC §306 Stock §3.112

3. Stock With Substituted Basis Included in Decedent's Estate §3.113

4. Stock Included in Decedent's Estate But Now Held by Another Person §3.114

G. Three-Year Inclusion Rule of IRC §§2035 and 303 §3.115

H. GST and IRC §303 §3.116

I. Planning for IRC §§303, 2032A, and 6166 §3.117

J. Midstream Incorporation of Farm §3.118

VI. QUALIFIED CONSERVATION EASEMENTS

A. Charitable Deduction Under IRC §§170 and 2055 §3.119

B. Charitable Contribution Limits for Qualified Conservation Easements §3.119A

C. Estate Exclusion Under IRC §2031(c) §3.120

© The Regents of the University of California

§3.1 I. OVERVIEW

A client has just walked into your office and says that he or she is a farmer or rancher or owns a vineyard. Now, you and Billy Crystal are the real city slickers here because the only livestock you have ever seen is in the children's petting zoo, and the only crops you have touched are in the produce section at the grocery store. Even though the farmer (hereafter used as a generic term for farmers, ranchers, and vineyard owners unless a specific reference is made to one or the other) has the same tax and business succession issues as any other business owner or estate planning client, there are some estate planning concepts and drafting techniques that apply only to farm and ranch estates and closely held businesses.

This chapter analyzes certain estate planning considerations relating to farms, ranches, and vineyards, as well as to other real property that is being used in an active trade or business. Basically, if the estate qualifies, IRC §2032A can provide an additional reduction in valuation for real estate for estate tax purposes up to a maximum reduction of $1 million in 2009 (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107), IRC §6166 will allow for the installment payment of estate taxes attributable to a closely held business over a period of 14 years at a very favorable interest rate, and IRC §303 will allow for a redemption of stock in a closely held business corporation to be taxed at capital gains rates instead of being treated as a dividend distribution.

NOTE: Historically, IRC §2032A has been thought of as applying only to farms and other similar properties, but it also applies to an active business that uses real estate in a nonfarm context.

As used in this chapter, farm and ranch estates are those for which the primary source of income is from growing and marketing agricultural products. Estates with substantial nonfarm assets that derive substantial income from nonfarm sources will present considerations in addition to those discussed in this chapter. This chapter presupposes knowledge of estate planning techniques and tax concepts.

© The Regents of the University of California

§3.1A A. Preliminary Considerations

At the outset, the practitioner undertaking estate planning for a farmer should ascertain the nature of the farming operation—whether it entails one type of farming or several different and distinct operations such as crops, animals, and fruit trees. Additionally, questions that arise in the closely held business context must be asked, such as does your client want the family to continue the business and, if so, are there any heirs who wish to do so; are there liquidity concerns of the estate in the case of continued operations and for payment of estate taxes?

If the client is interested in the continuity of the farming operation, the transfer of the operation to the next generation may be facilitated by having the operation in an entity or setting up each distinct part of the operation in a different ownership form, *e.g.,* separating real estate from the farm business and holding equipment in another entity. Not only may this facilitate additional valuation discount planning, it may also facilitate a greater use of IRC §2032A because the §2032A reduction in value only applies to real estate, not personal property. See §3.34-3.37. The entity approach may also allow for the isolation of liabilities for asset protection purposes.

An analysis of what should pass through the estate versus what should be given away during lifetime is necessary with due regard for the estate and gift tax consequences of a transfer.

NOTE: It has been suggested that, with an increasing applicable credit amount, the typical estate plan may consider using disclaimers for postmortem estate planning instead of an automatic bypass trust on the death of the first spouse. This would give the surviving spouse greater flexibility without unnecessarily burdening him or her with the administration of a trust when the possibility of a tax on the death of the second spouse is remote. The practitioner will need to weigh possible changes in the applicable credit amount as well as the fact that in 2011 the applicable credit amount will be rolled back to the $1 million level of 2003. In addition, there is a risk that, after the death of the first spouse, the surviving spouse will not file the qualified disclaimer within the required 9 months to accomplish the anticipated postmortem estate planning. See IRC §2518. Under *Lucas v Hamm* (1961) 56 C2d 583, 15 CR 821, the drafting attorney may even become responsible to the beneficiaries if the disclaimer is not made, so the attorney should consider carefully whether the postmortem disclaimer is appropriate with a borderline taxable estate.

Also, although beyond the scope of this chapter, planning for retirement and qualification for Medi-Cal must be addressed. See generally California Elder Law Resources, Benefits, and Planning: An Advocate's Guide (Cal CEB 2003).

As in general estate planning, if advising a married couple, the spouses should be advised of the potential conflicts, and the attorney must obtain the informed written consent of the spouses before proceeding. See Cal Rules of Prof Cond 3-310.

© The Regents of the University of California

§3.2 B. Nontax Considerations

As with nonfarm estates, planning includes many nontax considerations, *e.g.,* providing for management of assets in the event of disability, or ensuring that a child with a special need is adequately provided for. Farmers also are confronted with nontax considerations that are unique to farmers' estates. For example, will the farmland be devised to the children as tenants-in-common or will it be partitioned among several children?

If the land is presently farmed as a unit, and if it will continue to be farmed as a unit, the dispositive provisions of the will can be fairly simple. However, testators frequently wish to specify that particular parcels be devised to a certain child.

Specific devises raise both practical and legal problems that should be discussed with the testator. Farmers who choose to divide their farmland by a testamentary document (all references to testamentary include probate and nonprobate transfers) may be aware of the practical problems, but are unlikely to have considered the legal problems. The attorney must become familiar with the practical problems in order to anticipate and resolve the legal problems. For example:

- Can a particular parcel be farmed by itself, or is it dependent on another parcel for water or access?
- What is the source of irrigation water?
- Should easements be created for pipelines or irrigation canals?
- Does one parcel bear most of the cost of maintaining irrigation canals?
- Is electricity available to all parcels to operate pumps?
- Are mineral rights to be included in the specific devise, or are mineral rights to be distributed pro rata? If mineral rights are included, one child ultimately may receive significantly greater value if that child's parcel contains valuable minerals. If mineral rights are distributed pro rata, one child may find his or her farmland taken out of farm production by an oil company's well, causing that child to suffer the additional tax under IRC §2032A(c). See IRS Letter Ruling 8318070.

These and similar factual questions relating to the farmland should be considered by the testator or settlor who wishes to make specific devises of farmland to several beneficiaries. Legal questions the attorney must consider include:

- Will the farmland be divided into separate parcels?
- Will the proposed division be within the minimum acreage requirements of the county?
- Does the proposed distribution provision create an illegal subdivision?
- Is all of the farmland encumbered by one deed of trust? If so, one child's financial situation may well affect the ability of another child to finance his or her farm operation.

A will or revocable trust that provides for specific devises of separate parcels to each child ordinarily will need to be reviewed more frequently than a document that merely divides the estate into an equal share for each child.

- Will a change in the county minimum lot size defeat the testator's plan?
- Will a change in the testator's farm operation during lifetime affect the plan?
- If row cropland is improved to orchard or vineyard land, the equality of treatment of children is affected.
- Similarly, installation of a drip irrigation system on one parcel may distort what the testator previously considered an equitable division.
- A distortion can be aggravated if the testator borrows against all of his or her land in order to improve a portion of it, or against a portion of the land to improve all of it.
- Another factor to consider is the possibility of toxic waste or chemical contamination on one parcel or another. A child who receives the shop or equipment storage yard may find that past oil or chemical practices require cleanup costs

disproportionate to the value of the parcel.

AUTHOR'S ADVICE: Farmers rarely consult with the estate planner when making decisions on the operation of the farm. Yet farmers do many things in the ordinary course of farming that can materially change the effect of specific devises in a will. These problems can be avoided by avoiding specific devises.

© The Regents of the University of California

§3.3 1. Business Plan Along With Estate Plan

Because statistics indicate that businesses without a business plan are more likely to fail, the practitioner should consider advising the client to develop a business plan. Not only does it give the farmer a written record, it also provides an end-of-the-year checklist to see if goals were accomplished and what needs to be addressed in the coming year. More importantly, it also gives the successors a good road map for continuation of the business. The U.S. Small Business Administration has estimated that only 30 percent of family-run companies succeed into the second generation and only 15 percent survive to the third generation; the reason cited is the lack of an orderly succession plan. See http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sbp_exit.pdf.

Additionally, a business plan will give the practitioner some specific information about the farm. For example, if the plan indicates that the purchase of adjacent land is contemplated or, conversely, that certain currently-owned land is to be sold if a certain price can be realized, the impact on the qualification for IRC §§303, 2032A, and 6166 needs to be considered.

© The Regents of the University of California

§3.4 2. Management and Control Issues

For a farmer client who wishes to pass on the farm to his or her children, but is reluctant to let go of the property, the practitioner must devise a method that takes into account this psychological hurdle for succession planning, similar to any other closely held business such as control, management, and distribution issues. Often, the surviving spouse is not working the farm and needs to be provided for. Children may have different needs and wants. Some may live on and work the farm ("on-farm heirs"), and some may have moved away and set up separate lives and occupations ("off-farm heirs"). This issue can be addressed with the use of an entity, which will facilitate centralized control, provide for an oversight board of directors, as well as provide for a vehicle to transfer the farm intact during lifetime and/or on death to the heirs. Use of voting interests for the on-farm heirs and nonvoting interests for the off-farm heirs may be useful to combine control and risk in the same hands. Some minority and marketability discounts may be available as well. See chap 1.

If there are multiple owners of the farm, buy-sell agreements may be helpful to shift ownership interests between the heirs if the price and payment terms can be met by the remaining owners. See §§2.2-2.11. The practitioner should be very familiar with the issues raised by IRC §§2701-2704. See Business Buy-Sell Agreements, chap 2 (Cal CEB 1991).

It may be possible to split up the various farm operations and negotiate long-term leases between the entities, with each group of children owning a different entity. This would allow the on-farm heirs to control the assets they need while giving the off-farm heirs cash flow but no control over the assets needed in the farm operation. A commonly used technique is to divide the land among the family members, who then enter into long-term leases with the farm partnership, which actually operates the farm. Care must be taken, however, to make sure that the material participation and qualified use requirements of IRC §2032A are met.

Additionally, when the operations are split into multiple entities, assets of one entity may not be available as collateral for the debts of the other entities, or shareholder approval may be difficult to obtain. Also, if one corporation pledges assets for the debts of another corporation, there may be no legal consideration, and it may not be an enforceable pledge of assets unless it qualifies as an accommodation lien.

For liability isolation purposes, the transfer of money back and forth between the entities may not always be associated with the proper documentation, thereby furthering an alter ego argument.

© The Regents of the University of California

§3.5 3. Durable Powers of Attorney

Durable powers of attorney are especially useful in meeting the technical requirements of the Internal Revenue Code in planning farm estates. During the farmer's lifetime, the durable power of attorney allows the attorney-in-fact for an incapacitated farmer to engage in business and/or enter into leases so the farmland can continue to be used in a closely held business. IRS Letter Ruling 8327009. After the farmer's death, a durable power of attorney given by the spouse will ensure that the agent may sign the agreement under IRC §2032A(d) and will allow the agent to continue to devote the property to a trade or business by authorizing the agent to enter into an appropriate leasing arrangement. If incapacitated beneficiaries have not designated an agent to undertake such actions, a conservatorship proceeding may be required solely for the purpose of qualifying the decedent's estate for a special valuation or for IRC §6166 deferral.

An attorney-in-fact under a durable power of attorney may also disclaim, on behalf of an incapacitated farmer, property that would otherwise be inherited by the farmer. A disclaimer may be useful to prevent additional property from being subjected to tax in the farmer's estate, and also to prevent additional property from changing the ratio of farm to nonfarm assets, which may affect eligibility for qualification under IRC §§303, 2032A, and 6166.

For further discussion of durable powers, see California Durable Powers of Attorney (Cal CEB 1996).

© The Regents of the University of California

§3.6 4. Liquidity Issues

After death, the decedent's estate often faces a liquidity issue, especially in the context of a closely held business. In a typical estate, liquid assets are needed to pay estate settlement costs and estate taxes. Additionally, cash flow is necessary during the period of estate administration to pay for debts and the ongoing needs of the business as well as to provide for family necessities of life. If the farm is being retained, cash also may be needed to buy out off-farm heirs. When the farm is to be retained, sales of inventory, equipment, or even unwanted parcels of land (considering the step-up in basis) may provide adequate liquidity.

Closely held business assets may not have a ready market, and in some cases there may be a large discount associated with a potential sale. Additionally, the owners may have plowed all of their earnings back into the business and therefore may be personally cash poor. The valuation reduction rules of IRC §2032A and the installment payment of tax rules under IRC §6166 may help the closely held farm or business meet estate tax liabilities. See §§3.17-3.73, 3.80-3.104.

General concepts of liquidity planning such as life insurance, establishing reserves for taxes, and general valuation planning apply equally in the farm, ranch, and vineyard setting. Mortgaging property also may be an avenue, but the special lien granted the IRS in the event that IRC §2032A special use valuation and/or IRC §6166 installment payment of taxes is elected may make a deed of trust problematic, especially if done postmortem.

In the case of a proprietorship, partnership, or LLC, the ability to get cash out of the business to pay estate taxes does not generally create a significant income tax issue, because most of the time cash can be distributed without a liquidation or dividend tax consequence. With a C corporation, however, cash or other assets that are distributed create additional income tax issues. Generally, distributions are treated as dividends under IRC §301 to the extent that earnings and profits cover the distribution. If not, the distribution is treated as a return of capital, and distributions in excess of basis would be treated as capital gains.

If a closely held business C corporation has retained earnings, a distribution could very likely be treated as a taxable dividend. In the current taxing scheme, dividends are taxable at 15 percent, so the impact is not as great as when unearned income was taxed at 70 percent in the 1960s and 1970s. IRC §1(h)(1)(C), 1(h)(11).

With an S corporation, unless a special election is made under IRC §1368(c), the treatment of distributions from an S corporation with accumulated earnings and profits is determined under IRC §1368(c):

- As a return of capital that is nontaxable to the extent that it does not exceed the corporation's accumulated adjustment account;
- As a taxable dividend to the shareholder to the extent of the S corporation's accumulated earnings and profits;
- As a return of capital that is nontaxable to the extent of the remaining adjusted basis of the shareholder in his or her stock (note that the basis will be reduced initially by the nontaxable distribution to the extent of AAA mentioned in paragraph a); and
- As a capital gain for the remainder of the distribution.

If a dividend distribution falls within the exceptions of IRC §302, it will not be treated as a dividend but as a redemption and qualify for capital gains treatment. In a death situation, there would presumably be no capital gains as a result of the step-up in basis to fair market value at date of death. But meeting the IRC §302 exceptions and getting nondividend treatment, especially when family members are still involved in the business, is difficult to do.

When planning for liquidity, it is important to plan for the death of each spouse, taking into consideration whether the farming spouse or the nonfarming spouse dies first. If the farmer dies first and the surviving spouse has no desire or ability to work the farm, different problems need to be addressed, such as the material/active participation rules for IRC §2032A purposes.

The attorney should consider creating durable powers of attorney (DPA) for different purposes, such as one DPA for general nonfarm issues that is granted to an on-farm or off-farm heir, and another dealing DPA dealing only with farm issues that is granted to an on-farm heir.

Additionally, any nonmarital trust should provide for discretionary, not mandatory, distribution of income in order to allow the trustee to control the money for liquidity purposes and recapture-of-tax purposes.

© The Regents of the University of California

§3.7 C. Tax Considerations

Many of the tax benefits available for farmers' estates are available only if the estate qualifies by meeting certain requirements. One of the major tasks in tax-oriented estate planning for farmers is structuring the farm operation during the testator's lifetime to meet those requirements. Decisions to form family partnerships or to lease for crop-share rather than cash may be dictated more by estate planning considerations than by farm economics.

The testamentary plan may need to be structured if the farm operation is to remain viable after the testator's death. For example, in order to qualify for the benefits of IRC §2032A special valuation, all persons who have an interest in the qualified real property must consent to personal liability for additional estate tax, even if they do not elect special valuation with respect to their interests. Reg §20.2032A-8(c). See §3.55. But see *Estate of Marvin F. Pullin* (1985) 84 TC 789, acq 1988-2 Cum Bull 1, which held the regulation invalid insofar as it requires consent of cotenants whose interests were not acquired from the decedent. There are no cases dealing with the application of the regulation to cotenants who receive the property from the decedent but do not elect special valuation with respect to their interests.

Lifetime gifts require weighing income and estate tax benefits. See §3.14. Special circumstances may warrant paying estate tax on the death of the first spouse to die. See §3.10.

In making the decision to structure both the farm operation and the testamentary plan to reap the tax benefits available to farm estates, the primary factual consideration is whether the farming operation will be continued by the family.

© The Regents of the University of California

§3.8 1. Farming Operation Discontinued

If the farm operation will not be continued following the death or incapacity of the present generation, the practitioner should use customary estate planning principles commonly used by nonfarmers. Among those principles are the following:

- Deferring the estate tax through use of the unlimited marital deduction;
- Minimizing the tax on the second death through full utilization of the unified credit on the first death;
- Reducing the size of the taxable estate by lifetime gifts of appreciating property and annual exclusion gifts of nonappreciating property;
- Providing for liquidity through life insurance; and
- Retaining in the estate low-basis property to achieve the benefit of a step-up in basis on death under IRC §1014;

None of the above principles has any unique application to farm estates if the farming operation will be discontinued.

© The Regents of the University of California

§3.9 2. Farming Operation Continued

If the farm operation will be continued by the next generation, the principles in §3.8 can be used only after considering their effect on the farm operation.

The following techniques, applicable generally to small businesses, are addressed in this chapter:

- The IRC §2032A special use valuation of qualified real property to reduce the estate tax liability (see §§3.17-3.61);
- The use of IRC §6166 to obtain deferral and installment payment of estate taxes, if the farm is a closely held business (see §§3.80-3.104);
- The use of IRC §303, in the case of a corporate farm, to allow stock included in the estate to be redeemed at long-term capital gains rates and not at ordinary dividend rates, which facilitates withdrawal of cash or property from the corporation to pay for or replace dollars spent for estate taxes and administration expenses, and may provide cash to fund the buy-out of nonfarm heirs (see §§3.104-3.117);
- Buy-sell agreements, which can provide a structured transition to the on-farm heir (see §§3.15-3.16); and
- The use of qualified conservation easements (see §§3.119-3.120).

In addition, the treatment of income in respect of decedent (IRD) as it applies to decedent farmers is discussed in §§3.74-3.79.

© The Regents of the University of California

§3.10 3. Married Couple: Consider Paying Tax on First Death

Occasionally, special facts or circumstances will warrant paying tax on the death of the first spouse to die. Among the special facts that may justify paying tax in the first estate are the following:

(1) *Potential for short-term appreciation.* If it is anticipated that the property owned by the spouses will increase in value significantly between the death of the first spouse and the death of the surviving spouse, it may be preferable to allow the predeceased spouse's interest in the property to be taxed at the first death, thus avoiding a larger estate tax on that interest at the second death. However, with the repeal of the estate tax, and the reversion to the old unified credit amount of $1 million in 2011, this strategy may not continue to be advantageous.

(2) *Availability of tax deferral at favorable interest rates.* Paying tax on the first death may be worthwhile if all (or most) of the tax can be deferred under IRC §6166 at a 2-percent interest rate if that tax could not be deferred at a 2-percent interest rate on the second death. IRC §6601(j). See §3.81.

(3) *Maintenance of fractionalized ownership to justify valuation discounts.* If a QTIP election is made in the first estate, the QTIP property will be included in the survivor's estate under IRC §2044, but it will not be aggregated with other property owned by the survivor as a single consolidated interest for purposes of valuing the property of the survivor's estate, as would be the case if the marital property had been transferred to the survivor outright. This may save considerable tax if the surviving spouse and QTIP trust both own minority interests in a business that would constitute a majority interest if aggregated. See *Estate of Harriett R. Mellinger* (1999) 112 TC 26, acq 1999-2 Cum Bull xvi, corrected Announcement 99-116, 1999-2 Cum Bull 763. In *Estate of Rebecca A. Wineman,* TC Memo 2000-193, for example, the court allowed 15-percent "partial interest" discounts for 50-percent and 51-percent interests in large tracts of California ranch lands. But see *Estate of Aldo H. Fontana* (2002) 118 TC 318.

NOTE: In IRS Letter Ruling 8727001, the IRS ruled that a farm held in trust was entitled to be treated as a QTIP trust because (a) farm property is inherently capable of being income-producing, and (b) the governing instrument allowed the surviving spouse to force the sale and reinvestment in income-producing property.

(4) *Availability of the credit for tax on prior transfers.* When the first spouse to die leaves property in trust for the survivor and no QTIP election is made for the trust, the survivor's actuarial interest in the trust will be deemed to have been property transferred from the deceased spouse to the survivor. The estate tax paid in the first estate on that actuarial value will generate a credit for tax on prior transfers (TPT credit), which may be claimed in the second estate. If the survivor dies within two years of the first death, it will generally have been tax-beneficial to have paid tax on the first death. See IRC §2013.

© The Regents of the University of California

§3.11 4. Lifetime Gifting Program

A gifting program can be used to shift ownership to the younger generation in order to save on estate taxes as well as to start the retirement process for the parents. The annual exclusion of $13,000 per donee (adjusted annually for inflation; see Rev Proc 2009-50, 2009-45 Int Rev Bull 652; Rev Proc 2008-66, 2008-45 Int Rev Bull 1107) permits significant amounts of property to be transferred from a husband and wife to their children and/or grandchildren without any gift or estate tax and without use of the unified credit, as long as the gifts are made in a manner that does not result in their being treated as gifts of "future interests." IRC §2503(b). When property is expected to appreciate in value before the owner's death, lifetime gifts will remove the appreciation from the decedent's estate. When farm property with a history of significant appreciation is involved, the theoretical advantage of lifetime gifts is great.

It may be wise to begin the shifting of appreciation to the younger generation, but, under IRC §1014, lifetime gifts have a carryover basis equal to the donor's basis, while property retained until the donor's death receives a new date-of-death basis. When large gifts that will require payment of a gift tax are under consideration, it must also be recognized that the funds used to pay the gift tax will be taken out of the decedent's estate if the gift is made more than three years before the decedent's death. However, with the increasing applicable exclusion amounts and the repeal of the estate tax in 2010, any strategy that involves the payment of a gift tax may not be desirable.

NOTE: Lifetime gifts may also result in income tax savings if the younger generation is in lower tax brackets, but be aware of the "kiddie tax" for children if the child is younger than the taxpayer claiming the deduction and the child is either (1) under age 19 at the close of the calendar year or (2) a full-time student who is under age 24 at the close of the calendar year. See IRC §§1(g), 152(c)(3)(A).

© The Regents of the University of California

§3.12 a. Practical Problems of Lifetime Gifts of Farm Assets

Assets and property owned in connection with farming operations are not easily given as gifts in small increments. Farmland is usually owned in large blocks, and subdivision may be troublesome or impossible. Although it may be possible to obtain a substantial discount on the value of gifts of fractional interests (see §§3.14, 3.32), such gifts may be undesirable. Gifts of small, undivided interests can create significant future title problems, impair the farm operation during lifetime, and require expensive appraisals. For example, farmers may wish to refinance their land to pay for improvements such as permanent plantings or irrigation systems. The holder of a small fractional interest may balk at signing loan documents that impose joint and several liability in amounts that exceed the value of the small interest. Failure to secure the joinder of all land owners will probably be fatal to the proposed financing. Similarly, if a child to whom a fractional interest in real property has been transferred experiences marital or creditor problems, those problems may affect the parents' ability to obtain farm financing. Many farmers will not want to jeopardize their own operation during their lifetimes in order to save future estate taxes for their children.

Gifts of farmland may result in reevaluation for property tax purposes. See Cal Const art XIIIA. But note that certain intrafamily transfers are excluded from the change-of-ownership rules. See also §§1.52, 4.35. Gifts of farm equipment and depreciable improvements also may result in recapture of depreciation. See IRC §1245.

The assets and property used in a farming operation are usually an integral part of an overall operation, so the use of the property to be given away must be retained in some manner. Using life estates and lease agreements, however, can create the following problems:

- Retention of a life estate by the donors negates the advantage of the gift. See IRC §2036. In *Estate of Rebecca A. Wineman,* TC Memo 2000-193, however, the court held that a gift of a 24-percent interest in real property containing two residences and ranch buildings was not a transfer with retained interest, even though the donor continued to reside on the property. The donor did not have exclusive use of the property, her continued use was consistent with her retained interest, and her son gave credible testimony that there was no agreement concerning her use.

- A right retained under a lease agreement may also cause the gifted property to be included in the gross estate. IRS Letter Ruling 9146002.

- A leaseback of equipment may create cash-flow problems for a business with low income.

A solution to the practical problems of making lifetime gifts of farm property is to use a family corporation, trust, or family partnership. See §3.13. When farm property is used for lifetime gifts, the gift property may be made subject to a buy-sell agreement to ensure its availability to the farming operation in the event of the death of the donee or an election by the donee to make a lifetime disposition of the property. On buy-sell agreements, see §§3.15-3.16.

© The Regents of the University of California

§3.13 b. Use of Trusts, Family Corporations, and Family Partnerships

Using a trust, family corporation, or family partnership can successfully balance the competing interests of tax efficiency and retention of some kind of control by the older generation. Using such an entity can facilitate management and control as well as enhancing valuation discounts for gifting and estate tax purposes. For discussion of entity valuation planning and succession planning for a family business, see chaps 1-2.

© The Regents of the University of California

§3.14 c. Areas of Concern in Lifetime Gifts

Lifetime gifts can upset the components of the estate; they may have an impact on discount planning and certainly will affect the income tax basis of the gifted items.

When the assets of a farming operation or shares of a family farming corporation are given to children and/or grandchildren, care must be exercised in planning the gifts so the transfers do not cause a loss to the parents of valuable elections under IRC §2032A, §6166, or §303 by adversely changing the components of the total estate. See, *e.g.*, §§3.30 (IRC §2032A), 3.80 (IRC §6166), 3.105 (IRC §303) for applicable percentage requirements.

On the other hand, lifetime gifts may create an opportunity for discount planning. When shares of a family corporation are given away to such an extent that the stock retained by the parents represents only a minority interest, the stock in the parents' estates may be subject to valuation at a discount. Discounts create valuation problems that may require expensive appraisals. This expense may be justified by significant tax savings, however. See §3.32 and chap 1 on valuation and discount planning.

A major drawback of lifetime gifts is the loss of the step-up in basis for income tax purposes. When the assets of a farming operation or shares of a family farming corporation are given to children and/or grandchildren, the property held by donees will retain its historic basis carried over from the donors. IRC §1015. At the death of the parents, the donated property will not receive a new basis equal to the date-of-death value under IRC §1014 (unless the property is included in the donor's estate under IRC §2036). This loss of basis may be particularly significant when farming property is operated as a sole proprietorship or through a farming partnership, especially if the death of the parent occurs shortly before harvest of a valuable crop. Growing crops are not income in respect of a decedent. See Reg §1.691(a)-2, Example 5. See also §3.74. The crops are therefore entitled to a new fair market value basis under IRC §1014(a) at the owner's death. That basis will eliminate all or a significant part of the gain produced by a sale of the crop after the decedent's death if—but only if—the decedent owned the crop at the date of death.

A new basis under IRC §1014 may result in substantial income tax savings after death due to greater depreciation as well as a greater basis assigned to unsold crop. Rev Rul 58-436, 1958-2 Cum Bull 366. The postdeath income tax effect should be considered before making gifts of business assets. However, keep in mind that the maximum estate tax rate for 2008 and 2009 is 45 percent and that it applies to 100 percent of the property included in the gross estate, while the maximum federal income tax on capital gains is 15 percent and it applies only to the gain on the sale of the gifted property. Thus, the capital gains tax may very likely be far less than the estate tax.

© The Regents of the University of California

5. Buy-Sell Agreements

§3.15 a. Use of Buy-Sell Agreements

Parents who own property used in a farming operation can enter into a buy-sell agreement with one or more of their children who will take over the operation when one or both parents die. If all of the children will participate in the farming operation after the death of one or both parents, the buy-sell agreement may be used instead of a simple disposition to the children to fix the value of the assets used in the farming operation.

Internal Revenue Code §2703 provides that a buy-sell agreement will be disregarded unless it meets all three of the following requirements:

- It is a bona fide business arrangement;
- It is not a device to transfer property to members of the decedent's family for less than full consideration in money or money's worth; and
- Its terms are comparable to similar arrangements entered into by persons in an arm's-length transaction.

In addition, the purchase price fixed by the agreement must be representative of fair market value at the time the agreement is entered into, and the agreement must be binding on lifetime transfers as well as transfers at death. Consequently, using option agreements, buy-sell agreements, and similar devices in an attempt to freeze or establish the value of the subject property for estate or gift tax purposes must be approached with caution and considerable skepticism.

If fewer than all of the children are to participate in the farming operation after the death of one or both of the parents, the buy-sell agreement between the parents and the participating children has the further effect of substituting the proceeds of the sale for the farming assets in the parents' estates. An error in valuation can result in unfair treatment to the children who are to participate in the operation (if the price is too high) or to the children who will not participate (if the price is too low).

See §§2.2-2.12; Business Buy-Sell Agreements (Cal CEB 1991).

© The Regents of the University of California

§3.16 b. Disadvantages of Buy-Sell Agreements

A buy-sell agreement that is not bona fide will be subject to challenge and may not achieve its intended result in fixing values for estate tax purposes. IRC §2703; *Estate of Joseph H. Lauder,* TC Memo 1992-736. If the buy-sell agreement value is not binding for estate tax purposes but is nevertheless enforceable under state law against the estate, the estate may be forced to sell at a price that is insufficient to pay the estate tax.

When a farming operation is substantial, a buy-sell agreement may impose on the children who are to continue the farming operation a financial obligation that cannot be discharged from the income generated by the operation. This may be particularly true in an era of high land values that are in part inflated on the strength of projected future appreciation. Further, a buy-sell agreement may automatically trigger acceleration of estate tax that would otherwise be deferred. IRC §6166(g). See §§3.59-3.60.

© The Regents of the University of California

§3.17 II. SPECIAL USE VALUATION UNDER IRC §2032A

When vineyards, farms, or ranches are involved, the first issue to consider for both inter vivos and postmortem estate planning purposes is whether the estate qualifies for the IRC §2032A valuation reduction.

NOTE: Internal Revenue Code §2032A applies to farms as well as to real property held by a closely held business, but this section is most notably associated with farming operations.

© The Regents of the University of California

§3.18 A. Historical Context

The historical context of the valuation reduction lies in the congressionally recognized need to preserve family farms from sale and/or breakup and to preserve liquidity to pay estate taxes. See H Rep No. 94-1380, 94th Cong, 2d Sess (1976), reprinted in 1976 US Code Cong & Ad News 3356, 3375.

Generally, property will be included in the decedent's estate under IRC §2031 at its fair market value as of the date of death or at the alternate valuation date. Fair market value is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." Reg §20.2031-1(b). Fair market value presumes that land would change hands between a willing buyer and a willing seller based on the "highest and best use" to which that land could be put rather than the actual use of the land at the time it is transferred.

Thus, the application of highest and best use valuation in the farm, ranch, or vineyard context could lead to the immediate sale of the land and the termination of the farming operation when the surrounding land where the farm is situated is now being used at its highest and best use. With the valuation of the farm at this higher value, the heirs would not want to continue the operation of the farm in the face of a potential conversion to a higher and better use, especially because they are paying estate taxes at the higher and better use valuation. There would be no incentive to continue to operate the farm.

With the avowed purpose of maintaining family farms, Congress wrote IRC §2032A to be narrow in application; thus, the statutory framework is very detailed and technical. There are numerous barriers to the application of this section, the failure to meet any requirement being fatal to its application.

© The Regents of the University of California

§3.19 B. General Principal

Internal Revenue Code §2032A allows the estate to elect to report the value of qualified real property at its special use value, not its fair market value, which may result in considerable estate tax savings to the family farm or closely held business. However, the reduction in value from fair market value to special use value cannot exceed the maximum inflation indexed amount ($1 million for decedents dying in 2009 and 2010 (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107; Rev Proc 2009-50, 2009-45 Int Rev Bull 652)).

The special use value reduction under IRC §2032A is available only for estate tax purposes. No special use valuation is available for lifetime gifts of qualified property—those are valued at fair market value at date of gift. See IRC §2032A(a)(1). The special valuation rules under IRC §2032A may also apply to the generation-skipping transfer tax (GST) under certain circumstances. For a discussion of the GST consequences of §2032A, see §3.68.

Even though the estate can elect to reduce the value to special use value, the statute mandates the methods to be used in determining the special use value. The two methods set out in IRC §2032A(e)(7) and (e)(8) require the appraiser to look at rents and income, among other considerations, of the current use. See §§3.34-3.37.

With the gradual increase in the applicable credit amount as a result of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), the impact of the valuation reduction is being lessened with each exemption credit increase, because fewer and fewer farms will need to resort to the IRC §2032A reduction (until 2011 when the applicable credit amount reverts to $1 million under the EGTRRA-2001 sunset provisions).

© The Regents of the University of California

§3.20 C. Requirements for IRC §2032A Special Use Valuation

The special use valuation can be used if *all* of the following factors are satisfied:

- The decedent was a U.S. citizen or resident at the time of death. IRC §2032A(a)(1)(A).
- The real property is located in the United States. IRC §2032A(b)(1). The term "United States" when used in a geographical sense includes only the 50 states and the District of Columbia. IRC §7701(a)(9).
- At the date of the decedent's death, the real property was used by the decedent or a member of the decedent's family for a qualified use (*i.e.,* farming or in a trade or business). IRC §2032A(b)(1). See §§3.21-3.25.
- The real property was acquired from or passed from the decedent to a qualified heir of the decedent. IRC §2032A(b)(1). See §§3.26-3.28.
- At least 50 percent of the adjusted value of the gross estate must consist of the adjusted value of *real or personal property* that was being used for a qualified use, and that was acquired from, or passed from, the decedent to a qualified heir of the decedent. IRC §2032A(b)(1)(A). See §3.30.
- At least 25 percent of the adjusted value of the gross estate must consist of the adjusted value of qualified farm or closely held business *real property* that was acquired from, or passed from, the decedent to a qualified heir of the decedent. IRC §2032A(b)(1)(B). See §3.30.
- The real property was owned and used for a qualified use by the decedent or a member of the decedent's family during 5 of the 8 years before the decedent's death. IRC §2032A(b)(1)(C). See §3.38.
- There was material participation by the decedent or a member of the decedent's family during 5 of the 8 years before the decedent's death. IRC §2032A(b)(1)(C). See §§3.39-3.49.
- The executor files an election. IRC §2032A(a)(1). See §3.50.
- There is an agreement signed by all persons who have an interest in the property consenting to the imposition of a recapture tax if, within 10 years following the decedent's date of death (and before the qualified heir's death), the qualified heir disposes of the property or ceases to use the property for a qualified use. IRC §2032A(d)(2). See §§3.54-3.61.

© The Regents of the University of California

§3.21 D. Member of Family

Internal Revenue Code §2032A(e)(1) defines "member of the family" as

- An individual's ancestor;
- The individual's spouse;
- A lineal descendant of the individual, of the individual's spouse, or of the individual's parent; or
- The spouse of any such lineal descendent.

NOTE: Legally adopted children are treated as children by blood.

It is necessary to ascertain who the members of the family are (1) initially on the decedent's death to determine whether the qualified use and material participation requirements are met either by the decedent or a member of the decedent's family, and (2) during the 10-year period after the decedent's death to determine whether a qualified heir or a member of the qualified heir's family (who may or may not be a member of the decedent's family) is using the property for a qualified use.

NOTE: Predeath, either the decedent (who owns the property) or a member of the decedent's family must use the property; postdeath, the qualified heir who owns the qualified real property either must use the property for a qualified purpose or dispose of the property by giving or selling it to a family member who must then use it for a qualified purpose. Thus, postdeath, if the qualified heir continues to own the property but does not use it for a qualified use, even though a family member uses it for a qualified use, the recapture provisions may be triggered. See IRC §2032A(e)(1)-(2).

© The Regents of the University of California

E. Qualified Use

§3.22 1. Definition of Qualified Use

"Qualified use" is defined as the devotion of the property to use as a farm for farming purposes or use in a trade or business other than farming. IRC §2032A(b)(2).

Although IRC §2032A can be used to value real estate that is being used in a trade or business unrelated to farming, the distinction between farm real property and nonfarm real property is important because farm real property can be valued by the IRC §2032A(e)(7) capitalization-of-rents method or, on the executor's election, under the IRC §2032A(e)(8) five-factor test. Nonfarm real property can only be valued under the five-factor test. For discussion of valuation methods, see §§3.34-3.37.

The requirements for qualified use must be met both (1) at the date of the decedent's death, and (2) for the 10-year period of time following the decedent's death.

© The Regents of the University of California

§3.23 2. Definition of Farm

The term "farm" under IRC §2032A(e)(4) includes stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses, or other similar structures used primarily for the raising of agricultural or horticultural commodities, as well as orchards and woodlands.

Additionally, "farming purposes" are defined by IRC §2032A(e)(5) to mean:

- Cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm;
- Handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than one-half of the commodity so treated; and
- The planting, cultivating, caring for, or cutting of trees, or the preparation (other than milling) of trees for market.

Residential buildings and related improvements occupied on a regular basis by the owner or lessee of the real property or the owner's (or lessee's) employees for the purpose of operating or maintaining such real property, and roads, buildings, and other structures and improvements functionally related to the qualified use are treated as real property devoted to the qualified use. IRC §2032A(e)(3). Thus, this includes much more than just a house and attached garage.

Further, a farm residence occupied by the decedent owner of the specially valued property is considered to be occupied for the purpose of operating the farm even though a family member (not the decedent) was the person materially participating in the operation of the farm. Reg §20.2032A-3(b)(2). Thus, if the decedent owner was not living on the property but a member of his or her family was, the qualified use test has been met.

Under IRC §2032A(e)(13), the executor can elect to treat qualified woodlands as part of and valued with the real property, not as a growing crop, thereby making it part of the qualified use. Qualified woodland means any real property that (1) is used in timber operations, and (2) is an identifiable area of land such as an acre or other area for which records are normally maintained in conducting timber operations. The election to treat the qualified woodlands as land and not as crops must be made on the estate tax return and once made, is irrevocable.

© The Regents of the University of California

§3.24 3. Qualified Use and Leases

A farmland lease may have variations unfamiliar to an estate planning practitioner. All farm leases, in addition to normal real estate lease provisions, should address issues concerning (1) keeping the farm in good working order, (2) the planting and harvesting plan, (3) responsibility regarding expenses, (4) the type of remuneration each party is expecting for their contribution, (5) the marketing plan for the crop, and (6) how the crop shares are delivered.

Under a crop share lease, the landlord and tenant do not specify the amount of rent to be paid; rather, they specify their respective share of the income generated by the crop raised and sold by the tenant. The landlord's share is designed to reimburse the landlord for his or her land ownership expenses such as taxes, insurance, and land maintenance expenses to produce a return on investment and a reasonable profit for the risk incurred. The remainder goes to the tenant as a return on his or her effort. The tenant is usually responsible for the costs of operating the machinery such as fuel, maintenance, and repair costs. In some cases, the tenant may get a higher percentage if he or she is using state-of-the-art equipment that has higher operating costs.

Cash rent leases provide for a fixed amount for use of the land, equipment, and buildings. This results in the least amount of risk to the landlord (the tenant is unable to pay) and the most risk for the tenant (possible crop failure). The tenant receives all of the proceeds from the crop. Thus, the landlord's return is usually lower than in the crop share arrangement because the risk is lower. Normally, the landlord does not have any input in management or operational decisions. Consequently, with a cash lease, qualified use is more difficult to show except when a predeath cash lease is to members of the decedent's family.

© The Regents of the University of California

§3.25 4. At-Risk Requirement

The decedent or a member of the decedent's family must own an equity interest in the farm operation. Reg §20.2032A-3(b)(1). Thus, the real property must have been owned or deemed owned by the decedent or a member of his or her family and used for a qualified use by the decedent or a member of the decedent's family. One of the main criteria is whether the decedent or a member of the decedent's family was "at risk" regarding the real property.

PREDEATH EXAMPLE: If the decedent owned the land and cash-leased it to a family member for a qualified use, then the qualified use rules are met. If the decedent cash-leased the land to a nonfamily member, the qualified use requirement is not satisfied by the decedent as landowner and cannot be satisfied by a nonfamily member. See *Estate of Flora J. Abell* (1984) 83 TC 696; *Estate of Trueman v U.S.* (Cl Ct 1984) 84-2 USTC ¶13,590, 54 AFTR2d 6514. A lease of farmland to nonfamily members was held not to be a qualified use under IRC §2032A in *Estate of Opal P. Heffley* (1987) 89 TC 265, aff'd (7th Cir 1989) 884 F2d 279.

POSTDEATH EXAMPLE: A cash lease to anyone, including a family member, will be deemed a cessation of a qualified use unless it is during the two-year postdeath qualification period under IRC §2032A(c)(7)(A). See §§3.54-3.61 relating to cessation of use and recapture. Continuation of a cash lease by the qualified heir beyond two years after the decedent's death will forfeit the IRC §2032A benefits. *Martin v Commissioner* (7th Cir 1986) 783 F2d 81; *Williamson v Commissioner* (9th Cir 1992) 974 F2d 1525. If the qualified heir is the surviving spouse or a descendant of the decedent, however, the qualified heir can cash-lease the property to a member of the qualified heir's family without violating the qualified use requirement. IRC §2032A(c)(7)(E). It is still necessary for a member of the qualified heir's family to satisfy the material participation requirement. See §3.39. A crop share lease should satisfy the qualified use requirement, just as it usually satisfies the material participation requirement. See §3.22. The landlord is "at risk" because he or she shares in the expenses of the operation as well as in the risk of a lean year.

There are many variations on the crop share lease, but generally, the more the operational risk is shifted to the tenant, the less the decedent is "at risk," and it is more likely that the arrangement will run afoul of the "at risk" rules, the qualified use rules, and the material participation rules.

© The Regents of the University of California

F. Acquisition From or Passing From Decedent to Qualified Heir

§3.26 1. Acquisition From Decedent

The phrase "acquired from" is found in three places: (1) in the definition of qualified real property in IRC §2032A(b)(1); (2) in the 50-percent test of IRC §2032A(b)(1)(A); and (3) in the 25-percent test of IRC §2032A(b)(1)(B).

Property is acquired from the decedent if (IRC §2032A(e)(9)):

- The property is considered to be acquired from or passed from the decedent under the basis rules of IRC §1014(b);
- The property is acquired by any person from the decedent's estate (including purchase from the estate); or
- The property is acquired from a trust by any person if the property was included in decedent's gross estate.

Because only one of the three requirements must be met, the "acquired from" test generally will not be too difficult to pass.

© The Regents of the University of California

§3.27 2. Passing to Qualified Heir

The qualified property must pass to a qualified heir of the decedent and a qualified heir must use the property for a qualified use for 10 years. IRC §2032A(b)(1), (d)(2). A qualified heir is a member of the decedent's family (see §3.21) who acquired the property from the decedent or to whom the property passed from the decedent. IRC §2032A(e)(1). If the qualified heir sells the property to a member of his or her family, that person will be considered the qualified heir. IRC §2032A(e)(1). But if property passes to a nonqualified heir, a purchase from that heir will not suffice, because the property has not passed to a qualified heir initially.

Thus, it is imperative to determine who is to inherit the property and whether that person is a qualified heir. See §3.28.

NOTE: If a nonqualified heir is to receive qualified property, a qualified disclaimer under IRC §2518 that has the effect of allowing the property to pass to a qualified heir will protect the IRC §2032A special use election (even though a purchase by a qualified heir from a nonqualified heir would not).

© The Regents of the University of California

§3.28 3. Avoiding Successive Interest Problems

The regulations and a series of public and private rulings interpret the IRC §2032A(b)(1) requirement that the qualified real property pass to a qualified heir to mean that all successive interests in the qualified real property (*e.g.,* life estates and remainder interests) must vest in qualified heirs. Regulation §20.2032A-8(a)(2) provides:

If successive interests (*e.g.,* life estates and remainder interests) are created by a decedent in otherwise qualified property, an election under 2032A is available only with respect to that property (or portion thereof) in which qualified heirs of the decedent receive all of the successive interests, and such an election must include the interests of all of those heirs.… Where successive interests in specially valued property are created, remainder interests are treated as being received by qualified heirs only if such remainder interests are not contingent upon surviving a nonfamily member or are not subject to divestment in favor of a nonfamily member.

Under this regulation, even a remote possibility that the real property may pass to a nonqualified heir has been held to prevent an IRC §2032A election. IRS Letter Rulings 8332012, 8441006. The regulation was held invalid in three separate tax court cases. *Estate of David Davis IV* (1986) 86 TC 1156; *Estate of Carita M. Clinard* (1986) 86 TC 1180; *Estate of Susan L. Pliske,* TC Memo 1986-311. The IRS has not acquiesced in those decisions.

The statute, regulations, and rulings are extremely important to bear in mind when qualified real property is to be held by a trust. All income beneficiaries and all potential remainder beneficiaries of the trust should be qualified heirs. A gift-over to charity may disqualify the property from special valuation. Rev Rul 81-220, 1981-2 Cum Bull 175; IRS Letter Ruling 8407006. But see *Estate of David Davis IV, supra,* in which the Tax Court suggested that a wait-and-see approach be taken, *i.e.,* a remote gift-over to charity would not prevent initial qualification for special valuation. The IRS interpretation of the statute requires that the draftsman violate the rules of good draftsmanship concerning ultimate gifts-over.

Trusts often provide that if all of the testator's descendants die before distribution of the trust, then there will be an ultimate gift-over to heirs at law. Because there is a remote possibility that some of the property may be received by persons who are not members of the family within the meaning of IRC §2032A(e)(2) if the decedent's heirs at law all die before the termination of the trusts, a gift-over to heirs at law was held to disqualify the otherwise qualified real property from special valuation. IRS Letter Rulings 8332012, 8346006.

In order to avoid controversy over whether or not all interests in the qualified real property pass to qualified heirs, the ultimate gift-over provisions may need to be redrafted or eliminated. Eliminating the gift-over provisions raises the possibility of a partial intestacy. Insofar as IRC §2032A qualification is concerned, a partial intestacy does not create any problem, because the intestacy would be as of the testator's death, and the intestate takers would, in most cases, be qualified heirs. IRS Letter Ruling 8321007. Thus, while good draftsmanship abhors partial intestacies, the IRS interpretation of IRC §2032A encourages them. See *Estate of David Davis IV, supra*.

PRACTICE TIP: An alternative to intentionally creating a partial intestacy is to provide for the gift-over to heirs at law, but exclude from that class any persons who would not be qualified heirs under IRC §2032A. Until the successive interests controversy is finally resolved, gifts-over to charities should be avoided.

© The Regents of the University of California

§3.29 4. Powers of Appointment

Under Reg §20.2032A-8(2), "remainder interests are treated as being received by qualified heirs only if such remainder interests are not contingent on surviving a nonfamily member or are not subject to divestment in favor of a nonfamily member." To the extent that a power of appointment over any trust income or principal may be exercised in favor of a nonfamily member, the power of appointment may prevent the use of IRC §2032A. Whether the power of appointment may disqualify a §2032A election depends on whether the power is a general or special power, who holds the power, and who are the permissible appointees and takers in default under the power.

If the power is a general power of appointment, and if the holder of the power is a qualified heir, the power should not create any problems for §2032A qualification, whether or not the power is exercised. Because the property subject to a general power of appointment will be included in the estate of the qualified heir holding the general power of appointment, the successive interest rules should not apply. IRS Letter Ruling 8209004.

If the person holding a general power of appointment is not a qualified heir, however, the property subject to the power of appointment clearly will not qualify for special valuation, because an interest in the property has passed to a nonqualified heir.

Special powers of appointment present unique problems. The IRS has taken the position that if a qualified heir holds a special power to appoint trust property to someone other than a qualified heir, special valuation is not available. IRS Letter Ruling 8146020. When the qualified heir who receives the special power to appoint to a nonqualified heir makes a qualified disclaimer of the special power of appointment, special valuation is available as long as the takers in default of the power are qualified heirs. Rev Rul 82-140, 1982-2 Cum Bull 208.

In *Estate of Carita M. Clinard* (1986) 86 TC 1180, the Tax Court held that the mere possibility that a special power of appointment may be exercised in favor of a nonqualified heir will not preclude special valuation under IRC §2032A. The court reasoned that the provisions of §2032A(c), which provide for an additional tax in the event of early disposition to a nonqualified heir, were sufficient to ensure that the qualified real property stay in the family for the requisite period. The IRS has not acquiesced in the decision. Particular attention should be paid to drafting a special power of appointment. A special power to appoint to "children" may, by operation of Prob C §§26, 6450-6455, and 21115, include persons who are not qualified heirs within the meaning of IRC §2032A(e)(2). Similarly, a named permissible appointee who is presently the spouse of a descendant (and who would qualify as a family member under IRC §2032A(e)(2)) may become a nonfamily member as a result of divorce or death of a spouse followed by remarriage. IRS Letter Ruling 8412014. These problems suggest that the use of special powers of appointment be avoided unless careful analysis is given to all of the possible ramifications.

Clinard was followed by the Fourth Circuit Court of Appeals in *Estate of Thompson v Commissioner* (4th Cir 1989) 864 F2d 1128, in which the court held that otherwise qualified real property remains eligible for the special use valuation even when the qualified heirs have the power to appoint their interest to nonqualified heirs.

© The Regents of the University of California

§3.30 G. Percentage Tests and Adjusted Value

The adjusted value of the gross estate and the adjusted value of the qualified property must be compared to apply the 50-percent and the 25-percent tests. At least 50 percent of the adjusted value of the gross estate must consist of the adjusted value of *real or personal property* that was being used for a qualified use and that was acquired from, or passed from, the decedent to a qualified heir of the decedent. In addition, at least 25 percent of the adjusted value of the gross estate must consist of the adjusted value of qualified farm or closely held business *real property* that was acquired from, or passed from, the decedent to a qualified heir of the decedent. IRC §2032A(b)(1)(A)-(B). Note that personal property is excluded from the 25-percent test.

As long as an interest in real property meets all of the requirements of IRC §2032A, it is eligible for special use valuation even if other minor interests in the property are passed to and held by nonqualified heirs. *Estate of Thompson v Commissioner* (4th Cir 1989) 864 F2d 1128 (98-percent interest in property qualified under §2032A when interest valued at 2 percent or less was given to nonqualified heir); *Whalen v U.S.* (7th Cir 1987) 826 F2d 668 (special valuation allowed for 75 percent of farm left to three sons and disallowed for 25 percent of farm left to stepdaughter who was not qualified heir under prior law).

© The Regents of the University of California

§3.31 1. Determination of Adjusted Value

The adjusted value of the gross estate and the adjusted value of the real and personal property are determined without regard to IRC §2032A and reduced by any deductions allowable for mortgages and other indebtedness under IRC §2053(a)(4). IRC §2032A(b)(3)(A)-(B).

PRACTICE TIP: In close situations, it may be possible to meet the qualification test by paying off a debt before death because it may increase the equity in the property as well as reduce the amount of nonqualifying cash. The net effect would be an increase in the percentages of the qualifying property.

In addition, the appropriate discounts for marketability and minority interest under *Estate of Hoover v Commissioner* (10th Cir 1995) 69 F3d 1044, acq 1998-2 Cum Bull 254 (discussed in §3.32), will affect the adjusted values of the gross estate as well as the real and personal property.

If qualified property is held as community property, IRC §2032A(e)(10) suggests that the interest of the surviving spouse is taken into account to achieve a result that would have occurred if the property were not held as community property. Thus, for purposes of the 50- and 25-percent tests, the executor will look to the full value of the property to see if the estate meets these tests, but it appears that only the decedent's half of the community is included in the estate and is allowed to take the reduction. Presumably, the surviving spouse's half interest gets the full step-up in basis without the reduction.

© The Regents of the University of California

§3.32 2. Discount Planning

If the ownership facts present themselves properly, both the benefits of regular valuation discounts and special use valuation may be obtained.

The Tax Court has disallowed a minority interest discount for the outstanding stock of a closely held farming corporation when the corporation's farmland was valued under IRC §2032A. *Estate of Frances E. Wherry Maddox* (1989) 93 TC 228. In *Maddox,* the court held that a discount for minority interest could not be taken when the taxpayer attempted to take a marketability and minority discount from the special use value.

However, valuation discounts can still be used to determine the fair market value. In *Estate of Hoover v Commissioner* (10th Cir 1995) 69 F3d 1044, acq 1998-2 Cum Bull 254, the court indicated that the fair market value of the qualified use property could incorporate a marketability and minority discount to arrive at the true fair market value, and if the true fair market value exceeded the special use value by more than the limit, the maximum IRC §2032A reduction applied to the discounted fair market value. Thus, the court allowed the estate to take advantage of both techniques. See also IRS Letter Ruling 200448006.

Because the special use value cannot reduce the fair market value of the property by more than $1 million, if the special use reduction in value from the discounted fair market value is less than $1 million (the IRC §2032A limit for persons dying in 2009 and 2010 (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107; Rev Proc 2009-50, 2009-45 Int Rev Bull 652); see §3.19), the special use value is reported on the return. Thus, the proper procedure would be to first take the discount for minority interest and the discount for marketability to arrive at fair market value and then apply the $1 million reduction for further tax savings.

EXAMPLE: A decedent owned a half interest in an $8 million farm. The fair market value of the interest, including a 20-percent fractional share valuation discount, is $3.2 million, and the special use value, without regard to the $1 million maximum valuation reduction limitation, is $1.6 million. The special use value for the farm will be $2.2 million ($3.2 million - $1 million). The estate has benefited from both the valuation discount and the IRC §2032A election. However, the result is less favorable if the property is less valuable. Suppose the farm is worth $2.5 million. The fair market value of the half interest, including a 20-percent fractional interest discount, is $1 million, and the special use value without regard to the $1 million limitation is $500,000. In this case the estate tax value will be $500,000, and the estate receives no additional benefit from the fractional share discount.

NOTE: The special use valuation applies only to real property, not to equipment or other assets, but the discounts for minority interests and marketability apply to any type of asset. Thus, the land could be reported at special use value and the other assets can be reported with the marketability and minority discounts.

© The Regents of the University of California

§3.33 3. Three-Year Inclusion Rule Under IRC §2035 in Relation to Percentage Tests

For purposes of IRC §2032A, the value of the gross estate includes the value of all property which the decedent has at any time transferred, by trust or otherwise, during the 3-year period ending on the date of the decedent's death. IRC §2035(c)(1)(B). Thus, for purposes of the 50-percent and 25-percent tests, the gross estate includes all gifts made within three years of death of both qualifying property and nonqualifying property. Deathbed gifts of nonqualifying property made to increase the percentage of remaining qualified property in the estate as well as gifts of qualifying property would be brought back into the estate, which would increase the 25-percent and 50-percent amounts included in the estate.

NOTE: Internal Revenue Code §2035(c)(1) brings these gifts back in to the estate for IRC §2032A measuring purposes only; they are not brought back into the gross estate for estate tax purposes.

If no gift tax return was required to be filed, such as with an annual exclusion gift, a marital deduction gift, or a gift for the education-medical exclusion, the gift is not brought back in for measuring purposes (unless it is a life insurance policy). IRC §2035(c)(3).

EXAMPLE: The decedent gave away farm A to his children and paid a gift tax. He died 2 years later. All qualified use and qualified heir rules were met. Decedent also owned farm B at the time of his death and again, all qualified use and qualified heir rules were met. The decedent's adjusted gross estate without farm A was $600,000, the adjusted value of farm A was $90,000 and the adjusted value of farm B was $270,000. The IRS included both farm A and farm B under IRC §2035 and together they met the 50-percent test. However, because farm A is not included in the decedent's estate for estate tax purposes, farm A cannot be brought back into decedent's estate to meet the 25-percent test and the decedent's estate without farm A must meet the 25-percent test. Rev Rul 87-122, 1987-2 Cum Bull 221. This Revenue Ruling indicates that sufficient property to meet the 25-percent test must be specially valued and because farm A is not included in the estate, it cannot be specially valued and cannot be brought back in for the 25-percent test either. In this case, however, the estate did qualify because farm B comprised more than 39 percent of the estate without regard to farm A.

© The Regents of the University of California

§3.34 4. Determination of Special Use Value

Once the practitioner has determined that the 50- and 25-percent tests are met, the issue of actually valuing the land at the special use valuation must be considered. Under IRC §2032A, one of two valuation methods must be used: (1) the "farm method" or "capitalization of rents" method based on rental of comparable farmland and the Federal Land Bank interest rates (IRC §2032A(e)(7)), or (2) the five-factor method for real property not used in a farming business (IRC §2032A(e)(8)).

© The Regents of the University of California

a. Farm Method or Capitalization of Rents Method

§3.35 (1) Formula

The value of the farm for farming purposes is determined as follows: the excess of the average gross cash rental for comparable farming land in the locality over the average annual state and local real estate taxes for such comparable land, divided by the average annual effective interest rate for all new Federal Land Bank loans. IRC §2032A(e)(*7*).

Each average annual computation is to be made on the basis of the 5 most recent calendar years ending before the date of the decedent's death. IRC §2032A(e)(*7*)(A). It is not necessary to use rentals from the same tract of comparable property for each of these 5 years, provided an actual tract of property meeting the requirements of this section is identified for each year. Reg §20.2032A-*4*(b)(iv).

The IRS issues a Revenue Ruling each year listing the effective interest rates for each of the regional Farm Credit Bank Districts; the local interest rate of the district where the property is located should be used. Reg §20.2032A-*4*(e)(1). See, *e.g.,* Rev Rul 2008-44, 2008-32 Int Rev Bull 292. For 2008, the local interest rate for California is 6.09 percent.

The gross cash rental is the total amount of cash received for the use of actual tracts of comparable farm real property in the same locality as the property being specially valued during the period of 1 calendar year. This amount is not diminished by the amount of any expenses or liabilities associated with the farm operation or the lease. Reg §20.2032A-*4*(b).

The executor must identify to the IRS actual comparable property for all specially valued property and cash rentals from that property if the decedent's real property is valued under IRC §2032A(e)(*7*). If the executor does not identify such property and cash rentals, all specially valued real property must be valued under the rules of IRC §2032A(e)(8), discussed in §3.37. Reg §20.2032A-*4*(b)(2).

Only those cash rentals that result from a lease entered into in an arm's-length transaction are acceptable for comparison. Thus, leases between family members as defined in IRC §2032A(e)(2) that do not provide a return on the property commensurate with the return received under leases between unrelated parties in the locality are not acceptable.

Rents that are paid wholly or partly in kind (*e.g.,* crop shares) may not be used to determine the value of real property under IRC §2032A(e)(*7*) unless there is no comparable land from which to obtain gross cash rental. IRC §2032A(e)(*7*)(B); Reg §20.2032A-*4*(b)(2)(iii). In that case, net share rentals may be used. Net share rentals are defined as the value of the produce received by the landlord minus the cash operating expenses paid by the landlord. IRC §2032A(e)(*7*)(B)(ii).

No adjustment to the rents actually received by the lessor is made for the use of any farm equipment or other personal property the use of which is included under a lease for comparable real property unless the lease specifies the amount of the total rental attributable to the personal property and that amount is reasonable under the circumstances. Reg §20.2032A-*4*(b)(v).

© The Regents of the University of California

§3.36 (2) Comparable Real Property Defined

The regulations provide detailed guidance on the definition of comparable real property (Reg §20.2032A-4(d)):

Comparable real property must be situated in the same locality as the specially valued property. This requirement is not to be viewed in terms of mileage or political divisions alone, but rather is to be judged according to generally accepted real property valuation rules. The determination of properties which are comparable is a factual one and must be based on numerous factors, no one of which is determinative. It will, therefore, frequently be necessary to value farm property in segments where there are different uses or land characteristics included in the specially valued farm. For example, if [IRC §2032A(e)(7)] is used, rented property on which comparable buildings or improvements are located must be identified for specially valued property on which buildings or other real property improvements are located. In cases involving multiple areas or land characteristics, actual comparable property for each segment must be used, and the rentals and taxes from all such properties combined (using generally accepted real property valuation rules) for use in the valuation formula given in this section. However, any premium or discount resulting from the presence of multiple uses or other characteristics in one farm is also to be reflected. All factors generally considered in real estate valuation are to be considered in determining comparability under [IRC §2032A].

The following factors are among those to be considered in determining comparability (Reg §20.2032A-4(d)(1)-(10)):

- Similarity of soil as determined by any objective means, including an official soil survey reflected in a soil productivity index;
- Whether the crops grown would deplete the soil in a similar manner;
- The types of soil conservation techniques that have been practiced on the properties;
- Whether the properties are subject to flooding;
- The slope of the land;
- In the case of livestock operations, the carrying capacity of the land;
- If the land is timbered, whether the timber is comparable to that on the subject property;
- Whether the property as a whole is unified or whether it is segmented, and, if segmented, the availability of the means necessary for movement among the different segments;
- The number, types, and conditions of all buildings and other fixed improvements located on the properties and their location as it affects efficient management and use of property and value per se; and
- Availability of, and type of, transportation facilities in terms of costs and of proximity of the properties to local markets.

As can easily be seen, the use of this method is not just a drive-by appraisal by a real estate agent; it requires an in-depth study of the comparable land as well as an analysis of the economic environment in which the subject land is located.

NOTE: The regulations reflect the congressional mandate that the valuation analysis include some connection to the income-producing potential of the property. See H Rep No. 94-1380, 94th Cong, 2d Sess (1976), reprinted in 1976 US Code Cong & Ad News 3356, 3375.

© The Regents of the University of California

§3.37 b. Five-Factor Method

The five-factor test is used for:

- Nonfarm real property, *i.e.,* closely held businesses (IRC §2032A(e)(8)); and
- Farm real property, *if* (1) there is no comparable land from which to determine gross cash rents or net share rentals, or (2) the executor elects to use the five-factor test for the farm (IRC §2032A(e)(7)(C)).

An estate that fails to provide the required information for computing the special use valuation using the IRC §2032A(e)(7) "comparable rents" method will be deemed to have made an election to value the property under the IRC §2032A(e)(8) "relevant factors" method. *Estate of Rebecca A. Wineman,* TC Memo 2000-193.

For qualified real property used in a nonfarm trade or business or for a farm business valued under IRC §2032A(e)(7)(C), the following five factors are considered (IRC §2032A(e)(8)):

(1) The 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;

(2) The capitalization of the fair rental value of the land for farm land or closely held business purposes;

(3) Assessed land values in a state which provides a differential or use value assessment law for farmland or closely held business;

(4) Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price; and

(5) Any other factor which fairly values the farm or closely held business value of the property.

This method is used infrequently, however, because of the lack of IRS information on how this method actually is to be applied. See, *e.g.,* Rev Rul 89-30 1989-1 Cum Bull 274 (an executor may not elect one valuation factor to the exclusion of the other valuation factors, but the ruling is silent concerning the relevance and weight of each factor).

© The Regents of the University of California

§3.38 H. Duration of Qualified Use: Five Out of Eight Years

The qualified real property must have been owned and used for a qualified use by the decedent or a member of the decedent's family during a period aggregating 5 years or more of the 8 years before the decedent's death. IRC §2032A(b)(5)(C).

If the decedent was disabled or retired and the disability or retirement continued until the date of death, the 5-out-of-8-year rule must be met as of the date of disability or retirement. IRC §2032A(b)(4). Thus, if the decedent became disabled 2 years before dying and was continuously disabled until the date of death, whether the 5-out-of-8-year rule is satisfied is measured from the date of disability.

If the decedent was continuously retired or disabled until the time of his or her death, and the 5-out-of-8-year rule was met at the time of the retirement or disability, the decedent does not have to materially participate after the date of retirement or disability. Presumably, the decedent can retire, quit working the farm, and die many years later as long as the 5-out-of-8-year rule was met before retirement. But if he or she comes out of retirement, the 5-out-of-8-year rule must be met at the time of death.

© The Regents of the University of California

§3.39 I. Material Participation

The requirement of material participation by the decedent or a member of the decedent's family during 5 of the 8 years before the decedent's death is the most controversial issue under IRC §2032A. See IRC §2032A(b)(1)(C)(ii). The material participation requirement is intended to exclude owner-investors who are not involved in the farming or closely held business operation. Congress was interested in preserving family farms, not benefiting owners who were merely investors in a farming operation. The definitions and requirements of material participation are complex and varied, so a careful reading of this section is critical.

© The Regents of the University of California

§3.40 1. Active Management Rule for Surviving Spouse

If both spouses are materially participating in the farming operation, the death of one spouse does not create any special problems in meeting the material participation rules. However, satisfying the material participation rules is not so easy when one spouse is the primary farmer and the other spouse has another career or is the stay-at-home spouse. If the nonprimary farming spouse is the surviving spouse and he or she wants to keep the farm in the family, it would be very difficult to meet the material participation rules when the farmer dies, because the surviving spouse has never worked the farm and may have no interest in doing so. Internal Revenue Code §2032A(b)(5) recognizes this problem and requires active management by the surviving spouse, not material participation. See also IRS Letter Ruling 200911009.

NOTE: This section applies *only* to surviving spouses, not surviving members of the decedent's family.

© The Regents of the University of California

§3.41 2. Elements of Material Participation

Although material participation is the crux of IRC §2032A, this section defers to the rules under IRC §1402(a) relating to the self-employment tax to define what material participation is. If an activity constitutes material participation for self-employment tax purposes, it constitutes material participation for IRC §2032A purposes. Regulation §20.2032A-3(e)(1) presumes that if no self-employment tax is paid, there is no material participation, but the executor may still prove its case to the IRS and as a result, pay self-employment tax, penalties, and interest. The presumption does not work the other way, however: Payment of self-employment tax does not necessarily establish material participation.

Under the regulation, the following factors are considered in determining material participation (Reg §20.2032A-3(e)(2)):

- Physical work;
- Participation in management decisions;
- Regular advice and consultation on the farm operation;
- Regular inspection of production activities;
- Advancement of funds for the operation;
- Assumption of financial responsibility for a substantial portion of the expenses involved (in case of a farm, furnishing a substantial portion of the machinery, implements, and livestock used in the production activities); and
- Maintaining a principal residence on the premises.

Although no single factor is determinative, and each decision is heavily fact-based, physical work and participation in management decisions are considered "principal" factors by the regulation. If the decedent or a qualified family member worked at least 35 hours a week (or a lesser amount, if the lesser amount is sufficient to fully manage the farm), the material participation requirement is met. Reg §20.2032A-3(e)(1).

A different set of criteria is necessary when the farmer enters into a lease under which someone else is doing the work. See §3.43. IRS Publication 225, entitled Farmer's Tax Guide, provides helpful guidance for determining material participation under this circumstance. See §3.44.

© The Regents of the University of California

§3.42 3. Rental Arrangement and Material Participation: Includable Farm Rental Income

Internal Revenue Code §1402(a)(1) (to which the special use valuation rule refers; see §3.41) provides that net earnings from self-employment generally exclude rentals from real estate and from personal property leased with the real estate (including rentals paid in crop shares) together with the related deductions. However, there is an exception for any income derived by the owner or tenant of land (referred to as includable farm rental income) if (IRC §1402(a)(1)):

- The income is derived under a rental arrangement between the owner or tenant and another individual that provides that the other individual will produce agricultural or horticultural commodities on the land, and that there will be material participation by the owner or tenant in the production *or* management of the production of the agricultural or horticultural commodities; and
- There is, in fact, material participation by the owner or tenant with respect to any such agricultural or horticultural commodity.

The arrangement may be either oral or written but, as a practical matter, should be written and list as many of the activities assumed by the landlord as necessary to establish material participation. Reg §1.1402(a)-4(b)(3)(i). The arrangement must impose on the other person the obligation to produce one or more agricultural or horticultural commodities on the land of the owner or tenant. It must require material participation by the owner in either (a) the production or management of production or (b) the production and management of production when the total required participation in connection with both is considered.

PRACTICE TIP: Care must be taken when a nonfamily member uses the property and the decedent's participation is less than full time. The decedent must be actually participating in production or management according to an arrangement, either oral or in writing, the terms of which can be proved to the satisfaction of the IRS or the court. Reg §20.2032A-3(e)(1).

The term *production* refers to the physical work performed and the expenses incurred in producing a commodity, and includes such activities as the actual work of planting, cultivating, and harvesting crops, and the furnishing of machinery, implements, seed, and livestock. Reg §1.1402(a)-4(b)(3)(ii). Under the arrangement, it must be understood that the owner or tenant is to engage to a material degree in the physical work related to the production of such commodities.

The term *management of the production* refers to services performed in making managerial decisions relating to the production, such as when to plant, cultivate, dust, spray, or harvest the crop, and includes advising and consulting, making inspections, and making decisions on matters such as rotation of crops, the types of crops and livestock, and the types of machinery and implements to be furnished. Reg §1.1402(a)-4(b)(3)(iii). It appears that if the owner participates to a material degree in the management decisions relating to the production, he or she does not need to get his or her hands dirty.

© The Regents of the University of California

§3.43 a. Crop Share Versus Cash Rent

The various arrangements under which the decedent shares some of the farming operation can range from a pure cash rent with a tenant farmer to a crop share rent arrangement under which the decedent furnishes farm equipment. The latter moves the decedent closer to the material participation than the cash rent lease, which has no material participation.

As a general rule, if the decedent's earnings are deemed to be self-employment earnings under IRC §1402(a), the material participation requirements are met. See §3.41. However, rent received by the owner of farmland is not necessarily self-employment income under IRC §1402(a)(1), even if there is an agreement that the owner will materially participate in the farm's operation. *McNamara v Commissioner* (8th Cir 2000) 236 F3d 410. But see *Jere J. Solvie,* TC Memo 2004-55.

A crop share arrangement or other rental arrangement with material participation will be outside of the rental exclusion, thereby qualifying it for self-employment tax and material participation under IRC §2032A. Reg §1.1402(a)-4(b)(2).

© The Regents of the University of California

§3.44 b. Farmer's Tax Guide (IRS Publication 225) as Guidelines

IRS Publication 225, entitled Farmer's Tax Guide, explains the material participation criteria in the case of a landlord farmer. Under the heading "Landlord Participation in Farming," the publication states that generally, income and deductions from rentals and from personal property leased with real estate are not included in determining earnings subject to self-employment tax. However, they "are included if the rental arrangement provides that the landlord will, and does, *materially participate* in the *production* or *management of production* of the farm products on the land." (Emphasis added.) IRS Publication 225, p 76.

In addition to the material participation clause in the rental arrangement with the tenant, IRS Publication 225 requires the landlord to meet one of the following four tests.

- The landlord does any three of the following activities: (1) pays for at least half of the direct costs of producing the crop or livestock; (2) furnishes at least half the tools, equipment, and livestock used in the production activities; (3) advises or consults with the tenant; (4) periodically inspects the production activities.
- The landlord regularly and frequently makes, or takes an important part in making, management decisions that substantially contribute to or affect the enterprise's success.
- The landlord works at least 100 hours spread over at least 5 weeks in activities connected with agricultural production.
- The landlord does things that, when considered in their totality, show that the landlord is "materially and significantly involved" in production of the farm commodities.

These tests are general guides for determining whether a landlord qualifies as a material participant. If the landlord farmer meets one of these material participation tests at the time crop shares are produced, rent paid in the form of crop shares is included in earnings subject to self-employment tax. Feeding crop shares to livestock is considered using them, and thus includable farm rental income.

EXAMPLE: Drew Houston agrees to produce a crop on J. Clarke's cotton farm with each receiving half the proceeds. Clarke furnishes all the necessary equipment and advises Houston when to plant, spray, and pick the cotton. During the growing season, Clarke inspects the crop every few days to determine whether Houston is properly taking care of the crop. Houston furnishes all labor needed to grow and harvest the crop. The management decisions made by J. Clarke in connection with the care of the cotton crop and his regular inspection of the crop, along with all the necessary equipment he furnishes, establish that he participates to a material degree in the cotton production operations. The income Clarke receives from his cotton farm is included in computing his net earnings from self-employment. IRS Publication 225, p 76.

© The Regents of the University of California

§3.45 4. Use of Agent

If the personal involvement of the owner amounts to more than managing an investment even with the use of an agent or farm manager, one can still establish material participation by actually participating. Reg §§1.1402(a)-4(b)(5), 20.2032A-3(g). Regulation §20.2032A-3(e)(2) provides:

Retention of a professional farm manager will not by itself prevent satisfaction of the material participation requirement by the decedent and family members. However, the decedent and/or a family member must personally materially participate under the terms of the arrangement with the professional farm manager to satisfy this requirement.

© The Regents of the University of California

§3.46 5. Material Participation and Ownership by Entity

When the real property is indirectly owned through the medium of an entity, even full-time involvement by the entity's owner must be under an arrangement between the entity and the decedent or family member specifying the services to be performed. Reg §20.2032A-3(f). Holding an office in which certain material functions are inherent may constitute the necessary arrangement for material participation.

© The Regents of the University of California

§3.47 a. Partnership or Corporation

When the real property is not directly worked by the individual, but is leased to an entity or owned by an entity, such as an LLC for liability protection, the decedent or a qualified family member must meet the material participation challenge. Reg §20.2032A-3(f)(1). Additionally, the decedent's interest in the entity must meet the IRC §6166(b)(2) closely held business requirements. See §3.82. A partnership qualifies if 20 percent or more of the partnership is included in the decedent's gross estate or the partnership has 45 or fewer partners. IRC §6166(b)(1)(B). An interest in a corporation qualifies if 20 percent of the voting stock is included in the estate or the corporation has 45 or fewer shareholders. IRC §6166(b)(1)(C).

The midstream transfer of real property from a proprietorship to a corporation or partnership that meets the IRC §6166(b)(1) requirements allows the decedent to change the form of operation without jeopardizing the continuous use period. Reg §20.2032A-3(d).

Once the closely held business hurdle is met, however, the decedent still must fulfill the material participation requirement. Just being a corporate officer is insufficient—the decedent officer must participate in activities to such an extent that if the decedent were a sole proprietor, he or she would meet the material participation requirements and be subject to self-employment taxes. Reg §20.2032A-3(f)(2).

© The Regents of the University of California

§3.48 b. Trust

If the real property is owned by a trust, the arrangement requiring material participation generally will be found in one of the following situations (Reg §20.2032A-3(f)(1)):

- The arrangement may result from appointment as a trustee.
- The arrangement may result from an employer-employee relationship in which the participant is employed by a qualified closely held business owned by the trust in a position requiring his or her material participation in its activities.
- The participants may enter into a contract with the trustees to manage, or take part in managing, the real property for the trust.
- If the trust agreement expressly grants the beneficial owner management rights, that grant is sufficient to constitute the required arrangement.

Property transferred to a trust is considered to be continuously owned if the beneficial ownership of the trust property is such that the requirements of IRC §6166(b)(1)(C) (*i.e.,* the 20-percent/45-shareholder rule) would be satisfied if the property were owned by a corporation and all beneficiaries having vested interests in the trust were shareholders in the corporation. Reg §20.2032A-3(d).

© The Regents of the University of California

§3.49 c. Estate

During any periods when qualified real property is held by an estate, material participation is determined in the same manner as if the property were owned by a trust. Reg §20.2032A-3(f)(2). See §3.48.

© The Regents of the University of California

J. The Election

§3.50 1. Filing Election

The election required by IRC §2032A(a)(1)(B) must be filed with the estate tax return (IRS Form 706) (even if filed after the due date) and, once made, is irrevocable. IRC §2032A(d). Unlike IRC §6166 (installment payment of estate taxes), which otherwise parallels IRC §2032A, a late §2032A election will be valid but a late §6166 election will not. (However, a protective IRC §2032A election presumably cannot be made late. See §3.53.) A §6166 election must be made on a timely-filed return, including extensions. IRC §6166(d). See, *e.g.*, IRS Letter Rulings 200513014, 200523015, 200528019, allowing extensions of time for filing the §2032A election.

The election and agreement should be complete and accurate at the time of filing, but IRC §2032A(d)(3) allows a reasonable time, not exceeding 90 days after notification by the IRS, for the executor to provide required information and additional signatures to the agreement.

© The Regents of the University of California

§3.51 2. Content of Notice of Election

The notice of election should contain the following items (Reg §20.2032A-8(a)(3)):

- The decedent's name and taxpayer identification number as they appear on the estate tax return;
- The relevant qualified use;
- The items of real property shown on the estate tax return to be specially valued pursuant to the election (identified by schedule and item number);
- The fair market value of the real property to be specially valued under IRC §2032A and its value based on its qualified use (both values determined without regard to the adjustments provided by IRC §2032A(b)(3)(B));
- The adjusted value (as defined in IRC §2032A(b)(3)(B)) of all real property that is used in a qualified use and that passes from the decedent to a qualified heir and the adjusted value of all real property to be specially valued;
- The items of personal property shown on the estate tax return that pass from the decedent to a qualified heir and are used in a qualified use under IRC §2032A (identified by schedule and item number) and the total value of such personal property adjusted as provided under IRC §2032A(b)(3)(B);
- The adjusted value of the gross estate, as defined in IRC §2032A(b)(3)(A);
- The method used in determining the special value based on use;
- Copies of written appraisals of the real property's fair market value;
- A statement that the decedent and/or a member of his or her family has owned all specially valued real property for at least 5 years of the 8 years immediately preceding the date of the decedent's death (or disability or retirement; see §3.38);
- Any periods during the 8-year period preceding the date of the decedent's death during which the decedent or a member of his or her family did not own the property, use it in a qualified use, or materially participate in the operation of the farm or other business within the meaning of IRC §2032A(e)(6);
- The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use;
- Affidavits describing the activities constituting material participation and the identity of the material participant or participants; and
- A legal description of the specially valued property.

© The Regents of the University of California

§3.52 3. Partial Election

An election under IRC §2032A need not include all real property eligible for special use valuation, only sufficient property to satisfy the threshold requirements of IRC §2032A(b)(1)(B). Reg §20.2032A-8(a)(2). Thus, at least 25 percent of the adjusted gross estate containing real property must be the subject of the election. IRC §2032A(b)(1)(B).

EXAMPLE: If the entire estate consists of qualified real property and the special use valuation brings the value down by more than the applicable limitation amount (*i.e.,* $1 million for decedents dying in 2009 and 2010 (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107; Rev Proc 2009-50, 2009-45 Int Rev Bull 652)), the executor may want to consider only electing to treat enough property to meet the 25-percent test and not burdening the remainder of the property that will not benefit from the election.

See Rev Rul 87-122, 1987-2 Cum Bull 221. See also the discussion in §3.33 regarding the 25-percent test and the 3-year rule under IRC §2035.

© The Regents of the University of California

§3.53 4. Protective Election

Sometimes, at the time the estate tax return is due, the actual value of the special use property may be unclear. When this occurs, a protective election may be made to specially value qualified real property. The availability of a special use valuation under this election is contingent on the values, as finally determined (or agreed to following examination of a return), meeting the requirements of IRC §2032A. A protective election does not extend the time for payment of any amount of tax. Reg §20.2032A-8(b).

The protective election is made by a notice of election filed with a timely estate tax return stating that a protective election under IRC §2032A is being made pending final determination of values. This notice must include the following information (Reg §20.2032A-8(b)):

- The decedent's name and taxpayer identification number as they appear on the estate tax return;
- The relevant qualified use; and
- The items of real and personal property shown on the estate tax return that are used in a qualified use and that pass to qualified heirs (identified by schedule and item number).

If it is found that the estate qualifies for special use valuation based on values as finally determined (or agreed to following examination of a return), an additional notice of election must be filed within 60 days after the date of such determination. Reg §20.2032A-8(b).

The additional notice must contain the same information required as if an election was made on an original return (see §3.50) and the required agreement of the interested persons must be attached (see §3.55). An amended return is filed with this information included. The new return is filed with the IRS office where the original return was filed. Reg §20.2032A-8(b).

NOTE: The regulations indicate that notice of the protective election should be filed with a *timely* filed estate tax return, so it is advisable to not file late. Reg §20.2032A-8(b).

© The Regents of the University of California

§3.54 K. Recapture

For 10 years after the qualified heir receives the qualified real property, (1) the qualified heir may not dispose of any interest in the property (except to a member of his or her family), and (2) the qualified use of the qualified real property must be continued. IRC §2032A(c). Failure of either of these requirements results in a "forfeiture" of the special use valuation, plus interest. Without the recapture provision, the qualified heir who received the property could later sell it at full fair market value to a real estate developer, which would thwart the congressional goal of ensuring continued operation of family farms and small businesses owning real estate.

Partial cessation or disposition will result in a pro rata recapture.

© The Regents of the University of California

§3.55 1. Recapture Agreement

The executor must file a written agreement signed by each person in being who has any interest (whether or not in possession), as of the date of the decedent's death, in any property designated in such agreement, consenting to the application of the recapture provisions. IRC §2032A(a)(1)(B), (d)(2).

A person has an interest in qualified property if the interest, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate, whether present or future, vested or contingent. Included among these persons are (Reg §20.2032A-8(c)(2)):

- Owners of remainder and executory interests;
- Holders of general or special powers of appointment;
- Beneficiaries of a gift received in default of exercise of any such power;
- Cotenants, joint tenants, and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued; and
- Trustees of trusts holding any interest in the property.

Additionally, any member of the family of a qualified heir who purchases the qualified real property from the qualified heir should sign the agreement. See IRC §2032A(e)(1).

However, an heir who may have the power to affect disposition of the property by challenging a will under local law is not considered to be an interested person solely because of that right. Likewise, creditors of an estate are not interested persons solely because of their status as creditors. Reg §20.2032A-8(c)(2).

If the party who has any interest in the property being valued is a qualified heir, the agreement must express consent to personal liability under IRC §2032A(c) in the event of certain early dispositions of the property or early cessation of the qualified use. IRC §2032A(c)(6); Reg §20.2032A-8(c)(1). Parties other than qualified heirs with interests in the property must express consent to collection of any additional estate tax imposed under IRC §2032A(c) from the qualified property. The agreement must be in a form that is binding on all parties having an interest in the property. In addition, the agreement must designate an agent who will deal with the IRS on all matters arising under IRC §2032A. Reg §20.2032A-8(c)(1).

If any person required to enter into a recapture agreement wants an agent to act for him or her, or cannot legally bind himself or herself due to infancy or other incompetency, or to death before the election is timely exercised, a representative authorized under local law is permitted to sign the agreement on his or her behalf. Reg §20.2032A-8(c)(3).

PRACTICE TIP: If the practitioner anticipates that an estate has qualified real property, he or she should immediately ascertain who the potential beneficiaries may be, both qualified heirs and nonqualified heirs. If any are under a legal disability, the practitioner should seek to have a legal guardian or other representative appointed on behalf of those persons.

Form 706, Schedule A-1 contains detailed instructions on filing the §2032A election along with the agreement that must be signed.

© The Regents of the University of California

§3.56 2. Ten-Year Qualified Use Period

The qualified heir must continue to use the real property for the qualified use for a period of ten years from the date of the decedent's death. IRC §2032A(c)(1). This period may be extended for up to two years if, after the decedent's death, the qualified heir, *e.g.*, needs to convert a cash lease to a different type of arrangement to meet the qualified use requirements. IRC §2032A(c)(*7*)(A). For discussion of qualified use, see §§3.22-3.25.

If the qualified heir dies during the ten-year period while meeting the qualified use requirement, the recapture period ends for that heir. IRC §2032A(c). Thus, death will allow the estate of that qualified heir to escape recapture for early cessation. However, the recapture period continues for the other surviving qualified heirs.

NOTE: If qualified heirs receive successive interests such as life estates, the death of the first interest holder does not terminate the recapture period for the successive interest holders, who must still meet the qualified use requirements for the remainder of the recapture period. Reg §20.2032A-3(c)(2).

If there is a cessation and then later a disposition, the first event causes the recapture, and the second event is ignored.

© The Regents of the University of California

§3.57 3. Amount of Recapture

The amount of the recapture tax is basically the excess of the estate tax that would have been paid had no IRC §2032A election been made, minus the estate tax that was paid using the special use valuation. IRC §2032A(c)(2). This amount is called the adjusted tax difference. But note that the recapture tax cannot exceed the excess of the amount realized if sold (or fair market value if no sale) over the value of the interest at its special use value. IRC §2032A(c)(2)(A)(ii).

The recapture tax is due and payable 6 months after the date of disposition or cessation of qualified use. IRC §2032A(c)(4). IRS Form 706-A must be filed within 6 months of the recapture event and interest is due, beginning with the date of filing until the tax is paid. IRC §6601(a).

© The Regents of the University of California

§3.58 4. Grounds for Recapture of Tax

There are two events that result in recapture:

- *Disposition of the qualified interest.* The qualified heir no longer has an equity interest in the property. IRC §2032A(c)(1)(A). See §3.59.
- *Cessation of the qualified use.* The qualified heir fails to meet the material participation requirement. IRC §2032A(c)(1)(B). See §3.60.

© The Regents of the University of California

§3.59 a. Disposition of Qualified Interest

Disposition of an interest in the qualified real property to persons other than to members of the family of the qualified heir will cause recapture. IRC §2032A(c)(1)(A). Disposition to another qualified heir who is not a member of the transferor's family does not work.

A qualified heir who no longer has an equity interest in the property has disposed of it. IRC §2032A(c)(1)(A). Because a member of the decedent's family must own an equity interest in the farm operation, it appears that a cash rent lease would not meet that requirement. Reg §20.2032A-3(b)(1). See §3.43. However, a surviving spouse of a lineal descendant of the decedent may cash-rent the property to a family member of the spouse or the lineal descendant without triggering recapture. IRC §2032A(c)(7)(E).

There is a 2-year grace period after the decedent's death if the qualified heir needs to convert a cash lease to a different type of arrangement to meet the qualified use requirements. IRC §2032A(c)(7)(A).

NOTE: The granting of a conservation easement is not a disposition that subjects the qualified heirs to additional tax under IRC §2032A(c)(8). See IRS Letter Ruling 200608012 (granting easement in conjunction with leasing water rights on lands valued under §2032A did not constitute a cessation except with respect to portion of property specifically used for removing groundwater).

© The Regents of the University of California

§3.60 b. Cessation of Qualified Use

Internal Revenue Code §2032A(c)(6) indicates that when the original qualified use changes, even to another qualified use, a cessation of the qualified use has occurred and recapture results. A tax-free exchange under IRC §1031 does not cause cessation if the new property continues to have the same qualified use. IRC §2032A(i). Similarly, an IRC §1033 involuntary conversion is not deemed a cessation if the reinvestment rules are met. IRC §2032A(h). Additionally, for §1031 and §1033 exchanges, the client can tack the ownership, use, and participation periods from the original property to the replacement property. IRC §2032A(e)(14).

Failure to meet the material participation rule during an eight-year "rolling period" is considered cessation and results in recapture. IRC §2032A(c)(6)(B). The statute creates an eight-year rolling period beginning eight years before the decedent's death and ending eight years after his or her death. During the eight years, there can be no periods aggregating more than three years when there was no material participation by either the decedent or a member of the decedent's family before death, or by the qualified heir or a member of his or her family after the decedent's death. IRC §2032A(c)(6)(B). In addition to the material participation during this rolling eight-year period, the qualified use must exist during the entire ten-year period after the decedent's death.

For a surviving spouse, however, only active management is required, not material participation. See §3.40. The surviving spouse can add the decedent's material participation periods to the surviving spouse's active management to meet the five-out-of-eight-year material participation rule. IRC §2032A(b)(5)(C). See §3.38.

Further, for an eligible qualified heir, active management meets the material participation requirement. IRC §2032A(c)(7)(B). An eligible qualified heir is defined as a qualified heir who is the spouse of the decedent, a person who has not attained the age of 21, a person who is disabled, or a person who is a student within the meaning of IRC §151(c)(4). IRC §2032A(c)(7)(C).

When there has been an election to treat timber as qualified woodlands, the timber is not considered a crop but part of the land, and cutting and sale of the timber would constitute a partial disposition and recapture event only as it relates to the value of the timber. IRC §2032A(c)(2)(E), (e)(13).

Net cash rental to an unrelated party is considered a cessation of qualified use that resulted in additional tax. *Mary Jean Martin* (1985) 84 TC 620, aff'd (7th Cir 1986) 783 F2d 81. There are narrow exceptions to this general rule. In *Minter v U.S.* (8th Cir 1994) 19 F3d 426, the court held that continued leasing of farmland to a family farming corporation under identical arrangements to predeath qualified use was not a cessation of qualified use by the qualified heir that resulted in recapture. In *Estate of Gavin v U.S.* (8th Cir 1997) 113 F3d 802, the court found no cessation of qualified use because, under the facts of the particular case, the income from the cash lease to the decedent's son was dependent on production. Thus, if the tenant is a family member under a cash rent lease, the material participation requirement is satisfied by the activities of the family member as a tenant working the land.

For an example of farmland leased to nonfamily members held not to be a qualified use under IRC §2032A, see *Estate of Opal P. Heffley* (1987) 89 TC 265, aff'd (7th Cir 1989) 884 F2d 279.

© The Regents of the University of California

§3.61 5. Liability for Recapture Tax

The qualified heir is personally liable for the additional tax imposed with respect to his or her interest unless the heir has furnished a bond. IRC §2032A(c)(5). The qualified heir must consent to personal liability in the recapture agreement. IRC §2032A(d)(2). See §3.55.

A disposition to a family member of the qualified heir is a taxable disposition unless the transferee family member signs an agreement to be personally liable for any recapture tax. Such a disposition to a family member must be reported on Schedule C of IRS Form 706-A.

© The Regents of the University of California

§3.62 L. Lien for Taxes

A general estate tax lien attaches to all of decedent's property in order to secure the payment of the estate taxes. It is in effect for a period of 10 years following the date of death. IRC §6324(a). There is no requirement that this lien be recorded to be effective.

A lien for the adjusted tax difference under IRC §2032A(c)(2) (see §3.57) attributable to a qualified heir's interest attaches pro rata. IRC §6324B(a). This lien, however, must be filed in order to be effective. IRC §6324B(c)(1).

The lien will remain in place until the IRS determines that (1) the recapture tax has been satisfied, (2) the tax liability has become unenforceable by reason of lapse of time, or (3) that no further tax liability may arise. IRC §6324B(b).

© The Regents of the University of California

M. Miscellaneous Tax Considerations

§3.63 1. Basis of Farm Property Passing From Decedent for Income Tax Purposes (IRC §1014)

For purposes of the estate's or the heirs' income taxes, the adjusted basis of special use property is the special use value. IRC §1014(a)(3). Although this value may be higher than the adjusted basis in the hands of the decedent, it is still not the full step-up (or step-down, as the case may be) in basis to fair market value at date of death (or at alternate valuation date under IRC §2032) enjoyed by non-§2032A property.

© The Regents of the University of California

§3.64 2. Basis for Income Tax When Farm Property Sold (IRC §1040)

If the executor of the estate of any decedent transfers IRC §2032A property to a qualified heir in a purchase transaction, the estate recognizes gain on the transfer only to the extent that the fair market value of the property on the date of transfer exceeds the fair market value on the date of death. IRC §1040(a). Thus, the estate only recognizes the gain that it would have recognized but for the special use valuation. This rule applies only when the sale is to a qualified heir or §2032A property is distributed to satisfy a pecuniary bequest. See §3.70 on marital deduction planning.

The new basis for the purchasing qualified heir is the special use value, increased by the amount of gain recognized by the estate on the transfer. IRC §1040(c). Note that the heir's purchase price is not the new basis as it would be with non-§2032A property. The potential negative consequences must be carefully considered: Not only does the purchasing qualified heir not enjoy the full purchase price as the adjusted basis from which to take depreciation deductions while he or she owns the property but, on a later sale, gain (or loss) is calculated using that lower basis.

© The Regents of the University of California

§3.65 3. Holding Period for Capital Gain Purposes

For capital gain (or loss) purposes, a person who acquires property from a decedent under IRC §1014(b) and disposes of the property within one year of the decedent's death is considered to have held the property for more than one year if the property's basis is determined under §1014, regardless of when the decedent acquired the property. IRC §1223(9). Furthermore, if property to which IRC §1040 applies (see §3.64) is sold to a qualified heir within one year of the decedent's death, the person selling the property is deemed to have sold long-term property. IRC §1223(10).

© The Regents of the University of California

§3.66 4. When Considering Sale of Residence

For special valuation purposes, the farm residence can be included in the value reduction. IRC §2032A. Consequently, in deciding whether to sell the residence to take advantage of the IRC §121 exclusion of gain on sale (*i.e.,* $250,000/$500,000), the attorney must also consider whether a sale would jeopardize satisfying the requirement that at least 25 percent of the estate consist of the farm real property. IRC §2032A(b)(1)

NOTE: The residence also will be included in the 35-percent test under IRC §6166 if it is occupied regularly. IRC §6166(b)(3).

For IRC §121 purposes, it is necessary to determine how much land is included in the term residence, how much basis to allocate to the residence, and finally, if the residence is sold along with the farm, how to apportion the sales price of the entire farm to the residence portion. A loss on the sale of the residence is a personal loss and nondeductible, so care must be taken to allocate properly. See IRC §§1221, 1201. It may be possible to convert the residence to business use before the sale in order to claim a business loss under IRC §165.

© The Regents of the University of California

§3.67 5. Election for Basis Increase If Recapture Tax Imposed

A qualified heir who is subject to a recapture tax can make an election to increase his or her basis in the qualified property by an amount equal to the difference between the property's fair market value on the date of the decedent's death (or the alternate valuation date) and its special use value. IRC §1016(c)(1). The downside of making this election, however, is that the qualified heir must pay interest on the recaptured tax from the date the decedent's estate tax return was due to the date of the recapture. IRC §1016(c)(5)(B).

In the case of a partial disposition or cessation, a pro rata portion of the gain can be added to basis. IRC §1016(c)(2)(B).

© The Regents of the University of California

§3.68 6. Generation-Skipping Tax

Because farm operations tend to be viewed by their owners as family enterprises, it is common for interests in the operation to be transferred among family members of several generations. Although practical considerations often discourage transfers of land to grandchildren, those factors are of less concern when interests in a family partnership or stock in a family corporation are transferred. The practical problems associated with transferring land to a grandchild can be reduced by transferring the land to a trust of which the grandchild is a beneficiary, especially if a child is the trustee. Indeed, by leaving the farmland in a generation-skipping trust in which a child is the trustee and has an income interest for life, with the remainder interest passing to the grandchild, it is possible to pass the farming operation through several generations while insulating the largest capital asset from transfer tax at each generation.

Unimproved farmland, grazing land, and row crop land may be best suited for generation-skipping trusts. Farmland with trees, vines, or substantial improvements may be better taxed at each generation in order to obtain a step-up in basis on depreciable assets. The ability to depreciate improvements for income tax purposes from a stepped-up basis under IRC §1014 may more than offset the estate tax cost of inclusion in successive estates. This is especially true if the farmland is transmuted to community property at each generation, because the death of the first spouse to die will establish a new basis on depreciable assets without incurring any estate tax (assuming full use of the unified credit and marital deduction on the first death). On the death of the second spouse, to the extent that the property is included in the survivor's estate (under either IRC §2031 or §2044), a second adjustment to basis will be obtained. The income tax benefits of new depreciation over several lifetimes will often exceed the estate tax cost. Unimproved farmland, however, produces no immediate income tax benefit from a stepped-up basis, but is highly suitable for generation-skipping transfers. Full consideration of the generation-skipping transfer (GST) tax on intergenerational transfers is beyond the scope of this chapter. See generally California Estate Planning, chap 11 (Cal CEB 2002). Farm estate planners should be aware, however, of the relationship between the GST tax and the §2032A special valuation election.

Generally, property is valued for GST tax purposes at its value at the time of the generation-skipping transfer. IRC §2624(a). In the case of a direct skip, if the property is subject to an election under IRC §2032A in the transferor's estate, then the GST tax value is the §2032A value. IRC §2624(b). As a practical matter, most farmers are not likely to leave farmland to a grandchild by way of a direct skip. Only farmers whose children already possess a great deal of farmland are likely to skip their children and pass the farmland to the grandchildren by a direct skip. Usually, if a generation-skipping transfer is contemplated, the children are likely to have an intervening lifetime interest, with the result that the generation-skipping transfer is in the nature of a taxable termination rather than a direct skip. Farmland distributed to a grandchild in a taxable termination is not eligible for valuation under §2032A. See IRC §2624(b)-(c). Thus, any GST tax will normally be paid on the full value of the farmland distributed. IRC §2624(a).

Paying tax on the full value of the farmland makes the GST tax particularly onerous. If the farmland were left outright to the child (rather than in a GST trust in which the child has an income interest), the farmland would be eligible for valuation under §2032A in the child's estate (assuming the other §2032A requirements were met). Accordingly, if farmland is left in a trust to benefit successive generations, the estate planner should draft the trust to ensure that either (1) the trust has an inclusion ratio of zero, or (2) the trust will be includable in the gross estate of each generation (*e.g.,* by giving the child a general power of appointment over the trust).

For the trust to have a zero inclusion ratio, the value of the trust at the time of its creation (*e.g.,* at the grandparent's death) must not exceed the available GST exemption allocated to it. Under IRC §2642(b)(2)(A), for purposes of determining the inclusion ratio, the value of property transferred as a result of the transferor's death "shall be its value… for purposes of chapter 11." Thus, a GST trust consisting of real property having a fair market value of $1.75 million and a §2032A value of $1 million could have a zero inclusion ratio if the transferor's personal representative is able to allocate $1 million of GST tax exemption to the trust. This assumes compliance with Reg §26.2642-2(b), which provides that the denominator of the applicable fraction for computing the inclusion ratio for property subject to an IRC §2032A election will be the value determined under §2032A, as long as the recapture agreement filed under §2032A specifically provides for recapture of the GST tax. It is not difficult to imagine a situation in which the consent agreement requirement might be overlooked.

© The Regents of the University of California

§3.69 7. Proration of Estate Taxes Under Prob C §20114

When an election is made under IRC §2032A, Prob C §20114 provides that the qualified heirs who receive the qualified real property receive the entire benefit of the estate tax reduction resulting from the election and are also liable for the entire amount of any additional tax subsequently imposed on the property. Probate Code §20110(b)(1) allows the testator/settlor to modify this rule of proration. However, the practitioner should think carefully before modifying the default apportionment rules such as by making all taxes payable out of the residuary trust or residuary estate. When the default apportionment rules are modified to have all taxes paid from the residue of the estate, depending on the dispositive provisions, *e.g.,* if there are numerous specific bequests that do not bear the burden of estate taxes, all estate taxes will be paid by the remainder beneficiaries. This may not reflect the intent of the testator or settlor; even worse, it may deplete the residue to such an extent that the remainder beneficiaries receive far less than the testator anticipated.

© The Regents of the University of California

§3.70 N. Marital Deduction Planning

In planning for married couples, use of IRC §2032A involves several additional considerations. Should IRC §2032A be used when the marital deduction will be used to eliminate tax in the first estate? Should the interest of the predeceased spouse in the farmland be included in the marital share passing to the surviving spouse (outright or by QTIP trust), or should it be included in the nonmarital (credit shelter) share? If the farmland is included in the marital share, it will be included in the surviving spouse's estate for determining the percentage tests for qualification. If the property is to be specially valued in the first estate, the reduction in the farmland value under §2032A will shelter additional value from tax.

As a general planning option under a bypass/marital bequest, the bypass trust is not taxed in the estate of either spouse. The normal planning technique is to place the most rapidly appreciating assets into the bypass trust so that they are not included in the surviving spouse's estate on his or her death. In the farm scenario, normally depreciable assets are transferred in the marital bequest because they will receive a new basis for depreciation purposes. When the surviving spouse dies, the assets will be included in the surviving spouse's estate and again get a new cost basis equal to fair market value on the surviving spouse's death, which will be the new depreciation base for the children. Receivables and other items that are income in respect of a decedent under IRC §691 should be used to fund the marital share, because they will be diminished by the income tax payable when the items are received. See §3.74.

NOTE: Even though permissible under the law, using one trust and depending on a partial QTIP election to achieve tax savings may be ill-advised if the estate contains assets that would not qualify for the marital deduction (*e.g.,* a terminable interest), or if the estate contains assets with potential for substantial appreciation, *e.g.,* farmland on which a special valuation election is made under IRC §2032A. These assets are better placed in a separate bypass trust that is not intended to qualify for the marital deduction so that no part of the trust assets will be included in the surviving spouse's estate under IRC §2044.

© The Regents of the University of California

§3.71 1. Funding the Marital Share

In some cases, it is not desirable to place any of the farm assets in the nonmarital share. Indeed, it may be desirable to place the farm assets into the marital share so that the percentage of farm to nonfarm assets in the survivor's estate will be greater, to ensure that the threshold requirements for IRC §§303, 2032A, and 6166 are met.

Special use valuation is available at the first death, even in a zero-tax estate. If this is the case, a pecuniary marital formula with funding at date-of-distribution values can be used to supercharge the credit trust. Revenue Procedure 64-19, 1964-1 Cum Bull 682, sets forth the method for funding the marital deduction when a pecuniary formula gift is made by the will. Failure to comply with its provisions may result in partial loss of the marital deduction or in a deemed gift by the surviving spouse.

Several private letter rulings indicate that it is possible to elect special value on the first death and distribute the specially valued farmland to the surviving spouse at fair market value in satisfaction of a pecuniary formula marital deduction bequest. IRS Letter Rulings 8314001, 8314005, 8346046. It is apparent from the letter rulings that at least one district director disagreed with the national office. In *Estate of Henry M. Evers,* TC Memo 1989-292, the court ruled that the value of the farm properties for purposes of calculating the marital deduction was the §2032A value. The result may also be different when the marital share is funded by a specific devise or by operation of law. In IRS Letter Ruling 8422011, the IRS ruled that when property devised to a spouse was specially valued, the marital deduction was limited to the special value. Accordingly, practitioners should approach this technique with caution. Although it is appropriate to draft the will or trust agreement to achieve the goal suggested by the 1983 rulings, prudence suggests that a favorable ruling be obtained before the plan is actually implemented after death.

EXAMPLE: In 2009, the applicable exclusion amount is $3.5 million for each spouse (IRC §2010(c)), and the IRC §2032A value reduction limit is $1 million (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107). Using both exclusions and two times the special use deduction, a total of $9 million can pass estate tax free. On the first death, the pecuniary marital formula directs assets at date-of-distribution values to the marital share with non-prorata funding in kind allowed, satisfying Rev Proc 64-19, 1964-1 Cum Bull 682. The remainder of the estate, including the property for which special use valuation was elected, is transferred to the bypass trust. In addition, the trust instrument allows the trustee to allocate IRC §2032A property wherever he or she wants. Note that the marital trust will contain farm real estate that did not elect a IRC §2032A valuation, because the trust already reached the $1 million maximum reduction, and the specially valued property is transferred to the bypass trust.

On the surviving spouse's death, assuming that this estate also qualifies for the §2032A special use valuation on the remaining farm real property, the estate's value can be reduced by the $1 million valuation limit plus the second spouse's applicable exclusion amount of $3.5 million.

Although such a plan may achieve a substantial estate tax savings, care must be taken to avoid a disposition or cessation of use that would result in an additional tax under IRC §2032A(c). See §§3.59-3.60. Despite family intentions to continue farming, a weak farm economy such as that experienced during the mid-1980s may force a cessation of use and an imposition of an additional tax. The practitioner must explore the question of whether the farm family is better served by aggressive tax planning that imposes the burden of continuing the farming business during hard times or by less aggressive tax planning that allows the family to base decisions on economic rather than on tax effects. The estate tax savings of special valuation may be small in comparison to farming losses.

© The Regents of the University of California

§3.72 2. Funding the Bypass

By judicious use of the special valuation provisions of IRC §2032A in funding the nonmarital share, it may be possible to shelter an extra $1 million of farm real property for decedents dying in 2009 and 2010 (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107; Rev Proc 2009-50, 2009-45 Int Rev Bull 652; adjusted for inflation annually). Such a shelter is possible if IRC §2032A is elected in the first estate and if the nonmarital share is funded with the property to which the election applies.

The ability to use such a plan largely depends on the will provisions. Absent a requirement in the will, it is doubtful whether the executor can fund a nonmarital pecuniary bequest at special values if doing so distorts the beneficial interests. Unless the will provides otherwise, a pecuniary bequest by distribution of property other than money must be funded at fair market value on the date of distribution. Prob C §21118. Thus, if the will provides for an amount of property equal to the exemption equivalent to fund the bypass share, an election under IRC §2032A will be of no benefit. Accordingly, pecuniary bequests to the bypass share should be avoided in favor of a fractional formula bequest.

When the bypass and marital shares are defined by a fractional share formula clause, an election under IRC §2032A will increase the value of property in the bypass, thus decreasing the value of property passing to the surviving spouse to be taxed on the second death. The question is whether the specially valued property can be selected in its entirety to fund the bypass or if some of the specially valued property must be distributed to the marital share.

Use of a pecuniary formula marital bequest may facilitate planning for an election under IRC §2032A. The marital deduction amount is reduced by the IRC §2032A election, but is funded at date-of-distribution values. Rev Proc 64-19, 1964-1 Cum Bull 682. By funding the marital share with real property that has been specially valued, the funding is at fair market value, thus automatically increasing the bypass amount. Gain is recognized by the estate only in the amount by which the date-of-distribution value exceeds the date-of-death fair market value. IRC §1040. The primary disadvantage of the pecuniary formula marital bequest is that the estate will recognize gain if the values on the date of distribution exceed the fair market value on the date of death. The prospect of incurring a capital gain on distribution is not attractive to many testators.

Providing for a specific devise of real property to the bypass may be necessary in order to avoid the undesirable consequence of distributing low-basis specially valued property to the marital share.

Drafting the funding provision into the will can be extremely complicated, and may have undesirable consequences if circumstances change during the testator's lifetime. There do not appear to be any funding clauses that have universal application. Any clause designed for IRC §2032A funding needs to be carefully considered.

It is the author's opinion that aggressive planning to fund the bypass with IRC §2032A property is justified only in the very largest of estates. In the modest estate, the unified credits and maximum marital deduction yield no tax in the first estate; attempting to save tax in the second estate by imposing ten years of qualified use and material participation on the family may not be the most sound economic decision, especially during periods of a weak farm economy.

© The Regents of the University of California

§3.73 O. Pros and Cons of Using IRC §2032A Special Use Valuation

Even if the real property qualifies for the special use election, the practitioner must consider the following factors in deciding whether it should be used:

- The requirement of a tax lien for ten years may stifle future borrowing necessary for cash flow purposes, especially if the IRS is unwilling to subordinate and the lender will not take a second deed of trust. If borrowing is necessary to finance crop planting or equipment rentals or for general operational needs, that may be reason enough to forego the election.
- Does the particular farm operation facilitate the qualified use and material participation requirements before death and does the estate plan coordinate the continued qualification after death?
- Is the requirement to continue the qualified use for ten years too much of a burden?
- Is the loss of a full step-up in basis as well as the limited step-up to IRC §2032A value plus the gain recognized when property is sold to a qualified heir worth the estate tax savings?
- Does an IRC §2032A special use valuation reduce the estate to a point that it no longer qualifies for installment payments under IRC §6166 (less than 35 percent of the adjusted gross estate)? Does a partial IRC §2032A election qualify the remainder of the estate?
- Is splitting the farm among the children feasible?

© The Regents of the University of California

§3.74 III. INCOME IN RESPECT OF DECEDENT (IRD)

Income in respect of decedent (IRD) is income that a decedent was entitled to receive that was not properly includable in his or her taxable income before death; it is reported by its recipient (either the beneficiary or the estate). IRC §691.

The term IRD includes (Reg §1.691(a)-1(b)):

- All accrued income of a decedent who reported his or her income by use of the cash receipts and disbursements method;
- Income accrued solely by reason of the decedent's death in the case of a decedent who reports his or her income by use of an accrual method of accounting; and
- Income to which the decedent had a contingent claim at the time of death.

The general step-up-in-basis rule to fair market value at date of death under IRC §1014 (or at the alternate valuation date under IRC §2032) does not apply to property that constitutes a right to receive an item of income in respect of a decedent (IRD). IRC §§691, 1014(c). The recipient of IRD items receives a carryover basis from the decedent. To the extent that a beneficiary receives an IRD item, he or she is entitled to a corresponding income tax deduction for the pro rata amount of estate tax paid with respect to the IRD item. IRC §691(c).

The treatment of growing crops for farmers using the cash method of accounting is illustrated by Reg §1.691(a)-2, Example 5:

EXAMPLE 1: *A* owned and operated an apple orchard. During his lifetime, *A* sold and delivered 1000 bushels of apples to *X,* a canning factory, but did not receive payment before his death. *A* also entered into negotiations to sell 3000 bushels of apples to *Y,* a canning factory, but did not complete the sale before his death. After *A*'s death, the executor received payment from *X*. He also completed the sale to *Y* and transferred to *Y* 1200 bushels of apples on hand at *A*'s death and harvested and transferred an additional 1800 bushels. The gain from the sale of apples by *A* to *X* constitutes income in respect of a decedent when received. On the other hand, the gain from the sale of apples by the executor to *Y* does not.

EXAMPLE 2: Assume that, instead of the transaction entered into with *Y, A* had disposed of the 1200 bushels of harvested apples by delivering them to *Z,* a cooperative association, for processing and sale. Each year the association commingles the fruit received from all of its members into a pool and assigns to each member a percentage interest in the pool based on the fruit delivered by him or her. After the fruit is processed and the products are sold, the association distributes the net proceeds from the pool to its members in proportion to their interests in the pool. After *A*'s death, the association made distributions to the executor with respect to *A*'s share of the proceeds from the pool in which *A* had in interest. Under such circumstances, the proceeds from the disposition of the 1200 bushels of apples constitute income in respect of a decedent.

Thus, for an estate of a farmer using the cash method of accounting, growing crops are generally not IRD. See also §3.14.

© The Regents of the University of California

§3.75 A. Items of IRD for Farmer Under Different Lease Agreements

Items of IRD for the farmer include share rents collected by a landlord who does *not* materially participate and who uses the cash method of accounting. The IRS provides very detailed revenue rulings on how to treat income from livestock and farm crops depending on who raised them (farmer or tenant), at what point in time they were reduced to cash (before or after farmer's death), and whether the crop shares were used as feed.

NOTE: By negative implication, a materially participating landlord does not create IRD in the examples below.

If the decedent dies during a rent period, crop shares or livestock received as rent by a cash method decedent before death and still owned by him or her at the time of death, as well as crop shares or livestock that he or she had a right to receive as rent at the time of death for economic activities occurring before death, constitute IRD. These items must be included in the gross income of the person or entity who receives the income in the year in which the crop shares or livestock are sold or otherwise disposed of. Rev Rul 64-289, 1964-2 Cum Bull 173.

The amount to be allocated to IRD is determined by multiplying the proceeds by a fraction in which the numerator is the number of days in the part of the rental period that ends with the date of death of the landlord and the denominator is the total number of days in the rental period. The remainder is allocated to income of the estate.

Thus, only the net proceeds attributable to the portion of the rent period ending with decedent's death are IRD. The proceeds attributable to the portion of the rent period that runs from the day after death to the end of the rent period are ordinary income to the estate.

When crop shares or livestock received as rent are reduced to cash and received by the landlord before death, or received by the landlord in kind and sold before death, the proceeds thus received are includable in the decedent's final income tax return under IRC §61. No proration is required even though the rental period does not terminate until after death. Likewise, cash rent received by the landlord before death should be reported on the decedent's final income tax return. Rev Rul 64-289, 1964-2 Cum Bull 173.

Rents accrued at the date of the decedent's death constitute a part of the gross estate. Reg §20.2033-1(b). Thus, the items that constitute rent accruing before death are included pro rata on the decedent's last income tax return as well as on the estate's return. The allocation of inclusion in the gross estate would be based on an analysis of the daily proration during the rent period referred to above.

In Rev Rul 58-436, 1958-2 Cum Bull 366, as modified by Rev Rul 64-289, 1964-2 Cum Bull 173, the IRS ruled that for a cash method farmer, livestock and farm crops harvested or unharvested, raised by a decedent before death and held for sale or for feeding purposes by the decedent at the time of death, constitute items of property or inventory and not rights to, or items of, IRD. Basis is fair market value at date of death under IRC §1014.

However, in Rev Rul 75-11, 1975-1 Cum Bull 27, the IRS noted that the fair market value of crop shares received as rent by a farmer-landlord and used as feed in the farming operation must be included in the farmer-landlord's gross income at the time of such use (because in effect crop shares are thus converted into cash or its equivalent). The farmer is entitled to a deduction under IRC §162 at the same time and in the same amount as the income recognized. See also §3.44.

© The Regents of the University of California

§3.76 B. Transfer of Item of IRD

A transfer of an item of IRD by sale, exchange, or other disposition results in immediate taxation to the transferor. But note that the receipt of an item of IRD from the decedent's estate is not taxed until the income is received or the item is disposed of. IRC §691(a)(2). See also Reg §1.691(a)-4.

© The Regents of the University of California

§3.77 C. Holding Period of Farm Assets for Capital Gains Purposes

As a general rule, assets sold by the estate or beneficiary within one year of date of death generate long-term capital gain for all assets other than IRD. IRC §1223(9). However, this holding period is modified for "property used in the trade or business," which requires the following property to be held for more than one year:

- *Livestock.* (1) Cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, must be held by the taxpayer for 24 months or more from the date of acquisition, and (2) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, must be held by the taxpayer for 12 months or more from the date of acquisition. The term does not include poultry. IRC §1231(b)(3).

- *Unharvested crop on land.* If used in the trade or business and held for more than one year and if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop will be considered as "property used in the trade or business." IRC §1231(b)(4).

Thus, cattle, horses, livestock, and unharvested crop are considered ordinary income property unless they are held for the requisite time frame to enjoy long-term capital gains treatment.

EXAMPLE: Gain recognized from the sale of cattle and other livestock purchased on March 1, 1973, to be used as breeding stock by a decedent who died on May 1, 1973, that was sold July 2, 1973, by the decedent's estate, which continued the decedent's farming business, is ordinary income. The cattle and other livestock fail to qualify as property used in the trade or business under IRC §1231 (because they were not held the required 24 and 12 months, respectively) or as capital assets under IRC §1221 (because they were property subject to the allowance of depreciation). Rev Rul 75-361, 1975-2 Cum Bull 344.

© The Regents of the University of California

§3.78 1. Definition of Livestock

For purposes of IRC §1231, the term livestock is given a broad interpretation. It includes cattle, hogs, horses, mules, donkeys, sheep, goats, fur-bearing animals, and other mammals. However, it does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, or reptiles. Reg §1.1231-2(a)(3).

If an animal intended by the taxpayer to be used for breeding purposes is discovered to be sterile or unfit for the breeding purposes for which it was held, and is disposed of within a reasonable time thereafter, the animal is considered to be held for breeding purposes. Reg §1.1231-2(b)(2), Example 1.

© The Regents of the University of California

§3.79 2. Race Horses

A horse held for racing purposes is considered held for sporting purposes. Reg §1.1231-2(c)(1). Whether a horse is held for racing purposes is determined according to the following rules (Reg §1.1231-2(c)(1)):

- A horse that has actually been raced at a public race track is, except in rare and unusual circumstances, considered to be held for racing purposes.
- A horse that has not been raced at a public track is considered to be held for racing purposes if it has been trained to race and other facts and circumstances in the particular case also indicate that the horse was held for this purpose.

EXAMPLE: The taxpayer maintains a written training record on all horses he or she keeps in training status, which shows that a particular horse does not meet objective standards (including, but not limited to, such considerations as failure to achieve predetermined standards of performance during training, or the existence of a physical or other defect) established by the taxpayer for determining the fitness and quality of horses to be retained in the taxpayer's racing stable. Under these circumstances, if the taxpayer disposes of the horse within a reasonable time after determining that it did not meet the objective standards for retention, the horse is considered held for racing purposes.

- A horse that has not been raced at a public track nor trained for racing is not, except in rare and unusual circumstances, considered to be held for racing purposes.

© The Regents of the University of California

IV. INSTALLMENT PAYMENT OF ESTATE TAXES (IRC §6166)

§3.80 A. 14-Year Deferral

Congress recognized that even with a reduction in the estate tax values afforded to farms and closely held business real estate under IRC §2032A, requiring payment of estate taxes all at once could still be problematic with a main asset that is highly illiquid. Thus, the Internal Revenue Code provides for installment payment of estate taxes for qualifying estates at a low interest rate, with an initial deferral. IRC §6166. To the extent that the estate tax is paid in installments under the provisions of IRC §6166, a lien for payment of the tax is imposed on the assets of the decedent's estate, except for those used to pay debts and administration expenses, for 10 years after the date of the decedent's death unless paid in full sooner. IRC §6324.

If the value of the decedent's interest in a closely held business exceeds 35 percent of the adjusted gross estate, the executor may elect to pay the portion of the estate tax attributable to the closely held business in up to ten equal installments. The first installment of tax is due on or before 5 years and 9 months from the date of death, and successive installments are due annually thereafter. Interest installments are payable annually. IRC §6166(a). The value of the closely held business is the net value after reduction for business-related debts and encumbrances. See Rev Rul 80-202, 1980-2 Cum Bull 363.

PRACTICE TIP: In conjunction with the IRC §2032A election, the practitioner should consider the application of IRC §6166 when the decedent owned an interest in a farm or closely held business that comprises more than 35 percent of the adjusted gross estate. The 35-percent requirement will be tested against the special use value if IRC §2032A is elected. Thus, an election under IRC §2032A may reduce the value of the business to an amount below the 35-percent qualification threshold of IRC §6166.

The benefit of an IRC §6166 election is that for the first 5 years, interest only is paid at a reduced rate (on the estate tax attributable to the farm or closely held business), and thereafter the tax plus interest is due in 10 years. Note that the first payment of taxes is due 5 years from the date of death so the maximum deferral is 14 rather than 15 years.

The benefit of IRC §6166 is available only to a decedent who was either a citizen or resident of the United States. Just as with marital deduction planning, the practitioner must verify the decedent's status in the first meeting.

© The Regents of the University of California

§3.81 B. Calculation of 2-Percent Interest Rate

Perhaps the most important benefit to farmers who extend payment of the estate tax under IRC §6166 is the 2-percent interest rate (4 percent for date of death before January 1, 1998). Interest is paid at a 2-percent rate on the "2-percent portion" of deferred estate tax, compounded daily. IRC §§6601(j), 6622. The interest rate on the deferred estate tax in excess of the 2-percent portion is 45 percent of the regular underpayment rate. IRC §§6601(j)(1)(B), 6621.

The "2-percent portion" that can be deferred at 2 percent depends on the applicable credit and applicable exclusion amounts. The 2-percent portion is equal to the tentative tax on $1 million (inflation adjusted to $1.33 million in 2009 (Rev Proc 2008-66, 2008-45 Int Rev Bull 1107); $1.34 million for decedents dying in 2010 (Rev Proc 2009-50, 2009-45 Int Rev Bull 652)) plus the applicable exclusion amount minus the applicable credit amount under IRC §2010(c); however, if the amount so computed is more than the deferred estate tax under IRC §6166, the 2-percent portion is the lesser amount. IRC §6601(j)(2).

© The Regents of the University of California

§3.82 C. Interest in Closely Held Business

The term *interest in a closely held business* means (IRC §6166(b)(1)):

- An interest as a proprietor in a trade or business carried on as a proprietorship;
- An interest as a partner in a partnership carrying on a trade or business, if 20 percent or more of the total capital interest in the partnership is included in determining the decedent's gross estate, or the partnership had 45 or fewer partners; or
- Stock in a corporation carrying on a trade or business if 20 percent or more in value of the voting stock of the corporation is included in determining the decedent's gross estate, or the corporation had 45 or fewer shareholders.

© The Regents of the University of California

§3.83 1. Active Trade or Business

Unfortunately, IRC §6166 gives no definition of a trade or business; it does, however, state that a deferral is not available for passive assets, meaning any asset other than an asset used in carrying on a trade or business. IRC §6166(b)(9). Passive assets are only excluded for purposes of determining the closely held business amount under IRC §6166(a) but not for purposes of IRC §6166(g), relating to acceleration of amount due. IRC §6166(b)(9).

For a business interest to qualify as an interest in a closely held business under IRC §6166, the decedent must conduct an active trade or business or have an interest in an entity that carries on an active trade or business, not simply managing investment property. If the decedent participates in the management of the farming operations and his or her income is based on the farm production rather than on a fixed rental, the farm real estate is qualified as an interest in a closely held business, provided the 35-percent requirement is met. See Rev Rul 75-366, 1975-2 Cum Bull 472 (decedent's farms were operated by tenant farmers under agreements whereby decedent received 40 percent of the crops and bore 40 percent of the expenses; decedent participated in important management decisions, such as what crops to plant, what fields to plant or pasture, how to utilize the subsidy program, and what steps to take for weed control; decedent made almost daily visits to inspect and discuss operations, and occasionally delivered supplies to tenants).

Revenue Ruling 2006-34, 2006-26 Int Rev Bull 1171, provides guidance in determining whether real estate will be treated as a passive asset rather than property used in a trade or business. In general, the ruling compares the level and types of services performed by the decedent (or the business entity in which the decedent had an interest) with the services performed by independent contractors. Having nonemployees perform some services will not prevent the business from qualifying as an active trade or business unless the third party activities are so extensive that the activities of the decedent "are reduced to the level of merely holding investment property." Rev Rul 2006-34, 2006-26 Int Rev Bull 1171.

© The Regents of the University of California

§3.83A 2. Factors in Determining Whether Interest Is Active Trade or Business

Revenue Ruling 2006-34, 2006-26 Int Rev Bull 1171, provides a nonexclusive list of factors that the IRS will consider in determining whether a decedent's interest in real property is an interest in an active trade or business. The factors are:

- The amount of time the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) devoted to the trade or business;
- Whether an office was maintained from which activities of the decedent, partnership, LLC, or corporation were conducted or coordinated, and whether the decedent (or agents and employees of the decedent, partnership, LLC, or corporation) maintained regular business hours for that purpose;
- The extent to which the decedent (or agents and employees of the decedent, partnership, LLC, or corporation):
- Was actively involved in finding new tenants and negotiating and executing leases;
- Provided landscaping, grounds care, or other services beyond the mere furnishing of leased premises;
- Personally made, arranged for, performed, or supervised repairs and maintenance to the property (whether or not performed by independent contractors), including without limitation painting, carpentry, and plumbing; and
- Handled tenant repair requests and complaints.

The ruling also provides that no single factor is dispositive as to whether the decedent's activities constitute an active trade or business.

Revenue Ruling 2006-34 applies the factors to five "situations":

- In Situation 1, the decedent owned a 10-store strip mall, personally handled the day-to-day operation, management, and maintenance of the strip mall, and personally made most repairs. If an independent contractor was needed, the decedent personally selected the contractor and reviewed the work performed. The ruling concludes that the strip mall is an asset used in a trade or business.
- In Situation 2, the decedent owned a small office park consisting of five separate two-story buildings. Each building has multiple tenants. The office park is managed and operated almost entirely by a management company in which the decedent had no ownership interest. The ruling concludes that the office park is a passive asset.
- The facts in Situation 3 are the same as in Situation 2, except that the decedent owned 20 percent of the stock of the management company. As a consequence, it is necessary to take into account the nature of the services provided by the management company. Because these are extensive, the office park is an asset used in a trade or business.
- Situation 4 concerns a case in which the decedent was a 1-percent general partner and 20-percent limited partner in a partnership operating three strip malls. The partnership agreement required the general partner to provide the partnership with all services necessary to operate the partnership businesses, including performance of maintenance and repairs. The partnership paid the general partner a salary to perform those services. The ruling concludes that the strip malls are assets used in a trade or business.
- Situation 5 concerns an automobile dealership. The decedent owned all the stock of a corporation that operated the dealership. The real property where the business was conducted was owned by the decedent and leased to the corporation. The ruling concludes that the real property is an asset used in a trade or business.

Revenue Ruling 2006-34 is more favorable to taxpayers than Rev Rul 75-365, 1975-2 Cum Bull 471, which it revokes. That ruling concerned a decedent who maintained a fully equipped business office to collect rental payments on commercial and farm rental properties, receive payments on notes receivable, negotiate leases, make occasional loans, and "direct by contract" the maintenance of the properties. The IRS had concluded that the real properties were not used in a trade or business. Revenue Ruling 75-367, 1975-2 Cum Bull 472, is revoked with respect to the portion of that ruling that treated eight houses rented to tenants as a separate entity and held that they did not constitute interests in a trade or business.

© The Regents of the University of California

§3.84 3. Impact of Revenue Ruling 2006-34 on Farms

It is quite common for farmers to incorporate the farming operation but to retain ownership of the farmland outside the corporation and lease the land to the corporation. Many second and third generation family farms are conducted in partnerships in which the partners lease their individually owned land to the partnership, which is the operating entity. Such arrangements may be undertaken for tax purposes, but nontax motives are probably more frequent. Nontax motives may include compliance with acreage limitations imposed by reclamation laws or facilitating a testamentary plan under which the business is typically left to the on-farm heirs and land is left to the off-farm heirs (who will then lease the land to the on-farm heirs).

With these types of arrangements, however, care must be taken to meet the guidelines set out in Rev Rul 2006-34, 2006-26 Int Rev Bull 1171. In Situation 5, the decedent owned 100 percent of the stock of a corporation that operated an automobile dealership. The car dealership corporation was conducting an active business on real property that was owned directly by the decedent and leased to the corporation under a net lease. Because the decedent owned a significant interest in the corporation, and the corporation's employees performed all maintenance and repairs on the real property at the direction of the decedent, the decedent's interest in the real property qualified as an active business as well. Thus farm lease arrangements should be structured so that the decedent is actively involved in the management of the real property and not just a passive investor under a net lease.

Careful practitioners will avoid cash lease arrangements of the type discussed in IRS Letter Ruling 7917006 and will endeavor to have the landlord maintain an equity interest and participate in management decisions to keep within the limits of Rev Rul 75-366, 1975-2 Cum Bull 472. In a more beneficial ruling, the IRS held that a decedent's interest in a farm managed by her daughter and son-in-law constituted an active trade or business because the younger generation was acting as her agent. IRS Letter Ruling 8244003.

NOTE: In the author's opinion, a trade or business probably does not require the same level of participation as the material participation requirement of IRC §2032A.

© The Regents of the University of California

§3.85 4. Counting Partners and Shareholders; Family Attribution and Other Special Rules

A husband and wife are considered one partner or one shareholder if they own their interests as community property, joint tenants, tenants by the entirety, or tenants in common. IRC §6166(b)(2)(B).

Additionally, all stock and all partnership interests held by the decedent or by any family member (within the meaning of IRC §267(c)(4)) are treated as owned by the decedent. IRC §6166(b)(2)(D). Under IRC §267(c)(4), the family of an individual only includes brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

Property owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by or for its shareholders, partners, or beneficiaries. However, a person will be treated as a beneficiary of any trust only if the person has a *present* interest in the trust. IRC §6166(b)(2)(C).

Finally, an interest in residential buildings and related improvements on a farm can be counted towards the 35-percent threshold if these buildings are occupied on a regular basis by the farm's owner or lessee or by their employees for purposes of operating or maintaining the farm. IRC §6166(b)(3). This allows the residence to be included in the 35-percent calculation even if the farm was incorporated, as long as the residence was owned by the decedent.

© The Regents of the University of California

5. Adding Up Interests in Two or More Closely Held Businesses

§3.86 a. Adding 20-Percent Interests

In certain situations, a decedent may own interests in several different closely held businesses, such as separate entities for separate branches of the business, and none of the businesses alone would meet the 35-percent test.

Internal Revenue Code §6166(c) allows the estate to aggregate two or more businesses to meet the 35-percent test as follows: If the decedent owned 20 percent or more of each of two or more closely held businesses, the businesses will be treated as a single business. For purposes of the 20-percent requirement, the entire interest in a closely held business held by the decedent and the surviving spouse as community property, joint tenants, tenants by the entirety, or tenants in common is included in determining the value of the decedent's gross estate. IRC §6166(c).

© The Regents of the University of California

§3.87 b. Family Attribution for 20-Percent Test

The executor can elect to treat all non-publicly-traded stock and all partnership interests held by the decedent or by any family member (as defined in IRC §267(c)(4)) as owned by the decedent for the purposes of counting the 20-percent interests. IRC §6166(b)(2)(D). The family of an individual includes only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. IRC §267(c)(4).

Thus, for purposes of the 20-percent test, the executor can elect to include partnership interests and any non-publicly-traded stock owned by the decedent's family to meet the aggregation of two or more businesses to meet the 35-percent test (see §3.86), but there is a price to pay for using the family attribution rules (IRC §6166(b)(7)):

- All of such interests treated as owned by the decedent are treated as included in determining the value of the decedent's gross estate (but they will not actually be taxed in the gross estate);
- The 5-year deferral period is not available; and
- The 2-percent interest rate is not available.

As a result, the first installment of tax is due 9 months from date of death and the regular interest rate applies (IRC §6601(j)(1)(B) provides for the rate at 45 percent of the IRC §6621 federal underpayment rate).

There is no similar penalty under the IRC §6166(b)(1)(B)(ii) counting test when using family attribution even though both the counting and the 20-percent test are designed to bring more closely held businesses within the benefits of IRC §6166.

© The Regents of the University of California

§3.88 6. Holding Companies

Generally, stock held in another company is considered a passive asset (see §3.83), unless an election is made under IRC §6166(b)(8) for non-readily-tradable stock to qualify for installment payment. IRC §6166(b)(8)-(9).

But again, the election comes with a price: The estate loses the benefit of the initial 5-year interest only deferral and of the 2-percent interest rate. IRC §6166(b)(8)(A)(ii)-(iii).

© The Regents of the University of California

§3.89 D. Limitation on Tax Amount Payable in Installments

The maximum amount of tax that may be paid in installments is the amount that bears the same ratio to the estate tax imposed (reduced by the credits against the tax) as the closely held business amount bears to the amount of the adjusted gross estate. IRC §6166(a)(2). In other words, the installment payment election applies only to a proportionate amount of taxes generated by the interest in the closely held business. See IRC §6166(b)(6) for definition of adjusted gross estate.

Note that because the deferral is based on a percentage of the closely held business to the adjusted gross estate, in some cases the amount subject to deferral under IRC §6166 may be different from the actual tax attributable to the closely held business interest.

© The Regents of the University of California

§3.90 E. Timing of Payment of Installments

The first installment of tax must be paid on or before the date selected by the executor, which must be no later than 5 years after the date of death plus 9 months. Succeeding installment are due annually thereafter. IRC §6166(a)(3).

Interest payable on any unpaid portion of such amount attributable to any period after the 5-year period must be paid annually at the same time as, and as a part of, each installment payment of the tax. IRC §§6166(f)(2), 6601. Thus, future interest on the unpaid balance is due with each installment of tax paid.

If a deficiency is assessed after the close of the initial 5-year period, interest must be paid on notice and demand from the secretary. IRC §6166(f)(3).

If the executor has selected an initial deferral period shorter than 5 years, this shorter period is substituted for 5 years in the above paragraphs. IRC §6166(f)(4).

© The Regents of the University of California

§3.91 F. Filing Election

The election must be made not later than the time prescribed for filing the estate tax return under IRC §6075(a), including extensions (*i.e.*, 9 months after the decedent's death plus extensions). A late election is not allowed. IRC §6166(d). See also IRS Letter Ruling 200721006. But see §3.93 for election after deficiency has been assessed.

The election is made by attaching to a timely filed estate tax return (including extensions) a notice of election containing the following information (Treas Reg §20.6166-1(b)):

- The decedent's name and taxpayer identification number as they appear on the estate tax return;
- The amount of tax that is to be paid in installments;
- The date selected for payment of the first installment;
- The number of annual installments, including the first installment, in which the tax is to be paid;
- The properties shown on the estate tax return that constitute the closely held business interest (identified by schedule and item number); and
- The facts that formed the basis for the executor's conclusion that the estate qualifies for installment payment of the estate tax.

In the absence of a statement in the notice of election concerning (1) the amount of tax to be paid in installments, (2) the date selected for payment of the first installment, or (3) the number of installments, the election is presumed to be for the maximum amount payable and for payment in 10 equal installments, the first of which is due 9 months after the date of death. Treas Reg §20.6166-1(b).

© The Regents of the University of California

§3.92 1. Protective Election

Because the final value of the closely held business on the one hand and the values of the other assets in the estate on the other hand may be challenged and adjusted on audit, a protective election can be made to reserve the right to make the election when values are finally determined (or agreed to following examination of a return). Reg §20.6166-1(d). A protective election may be made to defer payment of any portion of tax remaining unpaid at the time values are finally determined (or agreed to following examination of a return) and any deficiencies attributable to the closely held business interest. A protective election does not, however, extend the time for payment of any amount of tax. Reg §20.6166-1(d).

A protective election is made by filing a notice of election with a timely filed estate tax return stating that the election is being made. Within 60 days after values are finally determined (or agreed to following examination of a return), a final notice of election must be filed with the IRS. Reg §20.6166-1(d). Notice of final election must be accompanied by payment of any amount of previously unpaid tax and interest due. Reg §20.6166-1(d).

© The Regents of the University of California

§3.93 2. Election After Deficiency Assessed

Internal Revenue Code §6166(h)(1) allows the estate to elect a §6166 installment payment of the taxes assessed after a deficiency assessment if the estate had not previously qualified under §6166 but does so after audit, unless the deficiency is due to negligence, intentional disregard of rules and regulations, or fraud with intent to evade tax.

The election must be made no later than 60 days after issuance of notice and demand by the IRS for the payment of the deficiency. The deficiency is prorated to the installments that would have been due if an election had been timely made at the time the estate tax return was filed. IRC §6166(h)(2)-(3).

© The Regents of the University of California

§3.94 G. Disposition of Interest in Closely Held Business; Acceleration of Tax Due

If 50 percent or more of an interest in a closely held business is sold, withdrawn, or otherwise disposed of, the estate loses its election to continue to pay on the installment basis and the deferred tax amount accelerates and becomes payable. IRC §6166(g). Transfers by reason of death will generally not accelerate the payment of the estate tax. IRC §6166(g)(1(D). See §3.95.

NOTE: A change in the form of business, *e.g.*, incorporation of a proprietorship, is not considered a disposition for acceleration purposes. IRS Letter Ruling 8220119.

© The Regents of the University of California

§3.95 1. Exceptions to Acceleration Rule: IRC §303 Redemption; Reorganization, and Disposition on Death

If a distribution in redemption of stock occurs to which IRC §303 applies, the redemption of the stock and the withdrawal of money and other property distributed in the redemption is not treated as a distribution or withdrawal for purposes of acceleration on the condition that if, on or before the date of the first installment of tax due after the date of the distribution, an amount of the estate tax not less than the amount of money and other property distributed is paid. IRC §6166(g)(1)(B)(i)-(ii). Thus, the withdrawal or distribution must be matched with an equal tax payment in order to not be treated as a disposition causing acceleration.

Additionally, a disposition does not take place when there is an exchange of stock pursuant to a D, E, or F reorganization under IRC §368(a)(1) or to a split-up or split-off under IRC §355. Likewise, a disposition does not occur in a transfer of property of the decedent to a person under the decedent's will, by intestacy, or to a trust created by the decedent.

A similar rule applies in the case of a series of subsequent transfers of the property by reason of death as long as each transfer is to a member of the family (within the meaning of IRC §267(c)(4)) of the transferor in such transfer. IRC §6166(g)(1)(C)-(D).

© The Regents of the University of California

§3.96 2. Holding Company Disposition

Any disposition of any interest in stock in a holding company that was included in determining the decedent's gross estate, or any withdrawal of any money or other property from such holding company attributable to any interest included in determining the decedent's gross estate, is treated as a disposition of or a withdrawal with respect to the qualifying stock. IRC §6166(g)(1)(E).

© The Regents of the University of California

§3.97 H. Undistributed Net Income of Estate

If the estate has undistributed net income for any taxable year ending on or after the due date for the first installment, the executor must, on or before the due date for filing the income tax return for such taxable year (including extensions), pay an amount equal to the undistributed net income in liquidation of the unpaid portion of the tax payable in installments. IRC §6166(g)(2)(A). This prevents the executor from accumulating income and not paying the IRS.

© The Regents of the University of California

§3.98 I. Failure to Make Payment of Principal or Interest

If any payment of principal or interest is not paid on or before the due date, the total unpaid portion of the tax payable in installments accelerates and must be paid on notice and demand from the IRS. IRC §6166(G)(3)(A). However, if the late installment payment is paid within 6 months of the due date, there is no acceleration of the total balance due, but that installment loses the benefit of the 2-percent rate, and a penalty equal to 5 percent of the late installment times the number of months by which it is late must be paid. IRC §6166(G)(3)(B).

© The Regents of the University of California

§3.99 J. Additional Lien Under IRC §6324A

Under IRC §2204, the executor can request to be discharged from liability for estate taxes within 9 months of the request, but, if the assessment period has not expired, the IRS can require the executor to post a bond under IRC §6165 for any amount that has not been paid. Instead of posting the bond, the executor may elect under IRC §6324A to have a special lien imposed on the estate property. However, the IRS cannot automatically require a bond or a special lien as a condition for permitting the §6166 election. *Estate of Edward P. Roski, Sr.* (2007) 128 TC 113.

In response to *Roski*, the IRS has issued Notice 2007-90, 2007-46 Int Rev Bull 1003, indicating that the IRS will now review on a case-by-case basis whether it will require a bond or lien when a §6166 election has been made. Under IRC §6324(a), the IRS is granted a general estate tax lien that attaches to all assets in the estate for 10 years after the date of death. However, because the §6166 election is made when the estate tax return is due (9 months after the date of death), the general estate lien will expire 9 years and 3 months later. Consequently, if all installments have been made on time, approximately 50 percent of the tax due will remain unpaid after the expiration of this 10-year period. Thus, the IRS is concerned that it will be unsecured for the final 4 years and 9 months of the 14-year installment period.

The IRS is developing regulations to identify the standards it will apply in determining whether the interest of the government is adequately secured in each case. As explained in Notice 2007-90, until the regulations are issued the IRS will evaluate factors including, but not limited to:

- The duration and stability of the business;
- The estate's ability to timely pay the tax installments and interest; and
- The business's tax compliance history.

The IRS will consider information contained in the estate tax return, attachments to the return, information obtained during examination in audited cases, and other relevant information. Estates that have filed returns that do not contain adequate information to make this determination may be contacted and required to provide additional information. The IRS may terminate an estate's §6166 election for failure to respond to such requests within a reasonable time.

If the IRS determines there is a sufficient credit risk regarding the government's collection of the deferred estate tax payments and interest, the IRS will notify the estate that it must provide a bond or elect to provide a §6324A special lien in lieu of a bond. If the estate refuses to provide a bond or a §6324A special lien, the IRS will terminate the estate's §6166 election.

If a §6324A election is made, the executor must designate "§6166 lien property" and all persons in being who have an interest in the §6166 property (whether they are in possession or not) must consent to the creation of the lien and designate an agent to deal with the IRS regarding the §6166 property and the lien. IRC §6324A(c). The lien must be recorded to be valid against third parties. IRC §6324A(d)(1).

If the value of the property covered by the agreement at any time is less than the unpaid portion of the deferred amount and the required interest amount, the IRS may require that property be added to the agreement. IRC §6324A(d)(5).

© The Regents of the University of California

§3.100 K. Generation-Skipping Transfer Tax (GST)

To the extent that an interest in a closely held business is the subject of a direct skip (within the meaning of IRC §2612(c)) occurring at the same time as and as a result of the decedent's death, any tax imposed by IRC §2601 on the transfer of such interest will be treated as if it were additional tax imposed by IRC §2001. IRC §6166(i).

Thus, the GST tax is treated as an estate tax and can be paid in installments as well.

© The Regents of the University of California

§3.101 L. Acceleration Under IRC §6166 and Its Impact on IRC §2032A

Note that the IRC §2032A recapture tax is owed by the qualified heir, not the estate. Thus, it will not affect the installment payments unless the recapture event is due to a disposition that would also trigger an acceleration of the installment payments under IRC §6166(g). A cessation of use is not an IRC §6166 disposition, although it will trigger a §2032A recapture.

© The Regents of the University of California

§3.102 M. Three-Year Inclusion Rule Under IRC §§2035 and 6166

An estate must meet the 35-percent test twice: first, with gifts made within three years of death included, and second, without gifts made within three years of death. IRC §2035(c)(2). If the 35-percent test is met at both points, the executor can elect IRC §6166 with regard to the closely held business interest included in the estate for estate tax purposes. This measurement is solely for §6166 qualification purposes; it does not require inclusion in the gross estate of such gifts. Gifts for which no gift tax return was filed are not counted in any event.

© The Regents of the University of California

§3.103 N. Other Estate Tax Considerations (QDOT, QTIP, Gift Tax)

QTIP property must be included in the estate of the second spouse to die. IRC §2044. The tax imposed on property includable under IRC §2044 is eligible for the installment payment of estate tax. Reg §20.2044-1(b).

The installment payment method can also be elected for any property remaining in a qualified domestic trust (QDOT) that is includable in the surviving spouse's gross estate (or would be includable if the surviving spouse were a U.S. citizen or resident). IRC §2056A(b)(10).

Internal Revenue Code §6166 does not apply to gift taxes.

© The Regents of the University of California

§3.104 O. S Corporation Stock

Revenue Ruling 76-23, 1976-1 Cum Bull 264 indicates that when S corporation stock is held by an estate that qualifies for the IRC §6166 election, the estate will continue to be an eligible shareholder for the installment payment period, and the administration of the estate would not be considered unreasonably long.

© The Regents of the University of California

V. IRC §303 REDEMPTIONS TO PAY DEATH TAXES AND ADMINISTRATION EXPENSES

§3.105 A. Use for Farming Corporation Stock

When an estate includes stock of a farming corporation, IRC §303 may permit the redemption of a portion of that stock with exchange treatment, even though the redemption would otherwise be treated as a dividend. If this exchange treatment is available under IRC §303, the redemption may be used to provide the estate with cash without significant income tax cost, because the stock redeemed will have a new cost basis equal to the date-of-death value under IRC §1014. The amount distributed in an IRC §303 redemption cannot exceed the total of federal and state death taxes (including interest) plus the deductible portion of all funeral and administration expenses under IRC §2053. Note that an IRC §303 redemption that exceeds the amount of federal estate tax paid may accelerate deferred tax under IRC §6166(g). See §3.101.

Internal Revenue Code §303 is available only if the value of the farming corporation stock included in the decedent's gross estate exceeds 35 percent of the excess of the total gross estate over the deductible expenses under IRC §2053 plus losses under IRC §2054. IRC §303(b)(2)(A). When a decedent owns stock in two or more corporations, the values can be combined to meet the 35-percent rule as long as the decedent (and surviving spouse, if any) owned 20 percent or more in value of each corporation's outstanding stock. IRC §303(b)(2)(A). See §3.106.

As long as the redemption occurs within 4 years after the decedent's date of death, IRC §303 does not require that any portion of the amount distributed actually be used to pay taxes or expenses. Therefore, IRC §303 redemptions may be used in tandem with an IRC §6166 election, in certain circumstances (see §3.95), to pay taxes in installments and give the estate cash for uses other than tax payments. (Special rules apply when withdrawals from the business under IRC §303 equal or exceed 50 percent of the value of the decedent's interest, or when an IRC §303 redemption occurs more than 4 years after the date of the decedent's death. IRC §§303(b)(4), 6166(g)(1)(B); Rev Rul 85-43, 1985-1 Cum Bull 356.) See §3.109. An IRC §303 redemption may also be used in tandem with a recapitalization to convert part of the decedent's stock to cash and part to preferred stock with a fixed dividend. Including the surviving spouse's interest in stock in the recapitalization may result in a freeze of the survivor's estate.

© The Regents of the University of California

§3.106 B. Aggregating Stock to Meet 35-Percent Test

Although the IRC §303 redemption opportunity is a factor in designing an estate plan, the specific use of IRC §303 is normally not defined until after the decedent's death. However, care must be exercised in planning to ensure that the other elements of the estate plan do not preclude use of IRC §303.

For purposes of the 35-percent test, when the decedent owns stock in more than one corporation, the stock of the corporations will be treated as the stock of a single corporation *if* the stock in each corporation equals or exceeds 20 percent of the decedent's gross estate. IRC §303(b)(2). For purposes of the 20-percent requirement, stock that, at the decedent's death, represents the surviving spouse's interest in property held by the decedent and the surviving spouse as community property or as joint tenants, tenants by the entirety, or tenants in common is treated as having been included in determining the value of the decedent's gross estate. IRC §303(b)(2)(B).

A redemption of stock from any thus combined corporation will qualify for IRC §303 exchange treatment, even if the corporation fails by itself to meet the 35-percent test as long as it meets the 20-percent test alone and then the 35-percent test when combined with another 20-percent corporation.

Note that, unlike for IRC §6166, there are no family attribution rules under IRC §303 nor shareholder counting limitations. The decedent's ownership interest stands on its own to meet the 35-percent test and/or the 20-percent test.

NOTE: Before the planner decides to incorporate the farm business in order to eventually take advantage of a IRC §303 redemption at death, he or she needs to analyze whether the corporate form is the best entity in which to conduct the business and what the tax ramifications of holding the assets in a corporation are. For example, IRC §§311, 336, and 337 require, with limited exceptions, the corporate-level recognition of gain on a corporation's sale or distribution of appreciated property, without regard to whether it occurs in a liquidating distribution or a sale in connection with a liquidation.

© The Regents of the University of California

§3.107 C. Use of IRC §303

A redemption can be accomplished in order for the estate to pay (IRC §303(a)):

- Estate, inheritance, legacy, and succession taxes;
- Interest collected as a part of these taxes; and
- The amount of funeral and administration expenses allowable as deductions to the estate under IRC §2053.

© The Regents of the University of California

§3.108 D. Relationship of Shareholder to Estate Tax

A redemption will qualify under IRC §303 only to the extent that the interest of the shareholder is reduced directly (or through a binding obligation to contribute) by payment of an amount distributed in the redemption towards estate tax, interest on such tax, or funeral and administration expenses. IRC §303(b)(3).

Thus, the redeemed shareholder must—directly or through contract—be obligated for the taxes. Therefore, the redemption usually falls on the heir or legatee who is ultimately obligated to pay estate taxes on property received, at least to the extent of the property received.

© The Regents of the University of California

§3.109 E. Time Frame Covered by Redemption

Internal Revenue Code §303 applies to distributions made after the decedent's death and (1) before the expiration of the 3-year limitations period for the assessment of estate tax (IRC §6501), or within 90 days after the expiration of that period, or (2) if a petition for redetermination of an estate tax deficiency has been filed with the Tax Court within the time prescribed in IRC §6213, at any time before the expiration of 60 days after the Tax Court's decision becomes final. IRC §303(b)(1)(A).

This means there is a 4-year period after the date of death in which to accomplish the redemption, because the estate tax return will be assessed 3 years after the return was filed (not including extensions), which is due 9 months after the date of death plus 90 days.

Distributions made *within* the 4-year period are limited to the sum of the federal and state death taxes and IRC §2053 funeral and administration expenses payable, but these amounts do not necessarily have to be paid during the 4-year period. *After* 4 years, however, any redemptions must be limited to an amount that does not exceed the payments of taxes and expenses actually made during the 1-year period after the redemption. IRC §303(b)(4).

© The Regents of the University of California

§3.110 F. Property Subject to Redemption

Internal Revenue Code §303(a) applies to a "distribution of property to a shareholder by a corporation in redemption of part or all of the stock of such corporation which (for Federal estate tax purposes) is included in determining the gross estate of a decedent."

© The Regents of the University of California

§3.111 1. Property Defined

"Property" is defined as money, securities, and any other property, except that the term does not include stock in the corporation making the distribution (or rights to acquire such stock). IRC §317. Thus, the distribution is not limited to cash but can include property that can be sold to generate cash.

All classes of stock included in the decedent's gross estate are available for redemption, including S corporation stock. See IRC §1368(e)(1)(B).

However, be aware that if appreciated property of the corporation (which does not get a step-up in basis to fair market value at the date of death because it is owned by the corporation) is distributed in redemption of the stock, there may be a deemed sale by the corporation of the appreciated property with a resulting tax that must be paid by the corporation. See *Kenan v Commissioner* (2d Cir 1940) 114 F2d 217.

© The Regents of the University of California

§3.112 2. Redemption of IRC §306 Stock

When there has been a distribution of stock to a shareholder and it is deemed to be a disguised dividend, the sale of the stock will result in ordinary income, not capital gains under IRC §306. However, under Reg §1.303-2(d), a distribution in redemption of stock will qualify under IRC §303 to the extent that the conditions of IRC §303 are met, notwithstanding the fact that the stock redeemed is IRC §306 stock.

© The Regents of the University of California

§3.113 3. Stock With Substituted Basis Included in Decedent's Estate

In addition to stock included in the decedent's estate, Reg §1.303-2(d) allows a redemption of stock that was not actually included in the estate but has a basis determined with reference to stock that was included in the decedent's estate. If stock included in determining the value of the gross estate of a decedent is exchanged for new stock, the basis of which is determined by reference to the basis of the old stock, the redemption of the new stock will be treated the same as the redemption of the old stock would have been.

Thus, IRC §303 applies with respect to a distribution in redemption of stock received by the estate of a decedent in connection with a reorganization, in a split-off or split-up, in a stock swap under IRC §1036, or in a stock dividend distribution. See also §3.112.

© The Regents of the University of California

§3.114 4. Stock Included in Decedent's Estate But Now Held by Another Person

Although IRC §303 most frequently will apply when stock is redeemed from the executor or administrator of an estate, the section also applies to distributions in redemption of stock included in the decedent's gross estate that is held at the time of the redemption by any person who acquired the stock by any means provided in IRC §§2031-2046, including the heir, legatee, or donee of the decedent, a surviving joint tenant, surviving spouse, appointee, or taker in default of appointment, or a trustee of a trust created by the decedent. Section 303 also may apply to the redemption of stock from an estate beneficiary to whom an executor has distributed the stock under the terms of the decedent's will. Reg §1.303-2(f).

Note, however, that if a person acquired the stock as a gift or a purchase from someone who received it directly from the decedent, the stock will not qualify. Thus, if an heir sold stock that he or she received from the decedent to a third party, the stock would not qualify for redemption.

Additionally, if a beneficiary was entitled to a specific bequest of money and the executor gave the beneficiary stock instead, this stock also would not qualify for the IRC §303 redemption.

© The Regents of the University of California

§3.115 G. Three-Year Inclusion Rule of IRC §§2035 and 303

For purposes of the 35-percent test, "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, during the 3-year period ending on the date of the decedent's death." IRC §2035(c)(1)(A). However, this rule includes the stock only for measurement purposes, not for gross estate purposes. In Rev Rul 84-76, 1984-1 Cum Bull 91 (decided under former law), stock gifted away by the decedent within 3 years of death was included in his estate for purposes of measuring for the 35-percent test; however, because this stock was not actually included in the decedent's estate for tax purposes, this measuring stock itself could not be redeemed under IRC §303.

© The Regents of the University of California

§3.116 H. GST and IRC §303

When stock in a corporation is the subject of a generation-skipping transfer occurring at the same time and as a result of the death of an individual, the following rules apply (IRC §303(d)):

- The stock is deemed to be included in the gross estate of the individual;
- Taxes of the kind referred to in IRC §303(a)(1) that are imposed because of the generation-skipping transfer are treated as imposed because of the individual's death (and for this purpose the GST tax is treated as an estate tax);
- The distribution period is measured from the date of the generation-skipping transfer; and
- The relationship of stock to the decedent's estate is measured with reference solely to the amount of the generation-skipping transfer.

© The Regents of the University of California

§3.117 I. Planning for IRC §§303, 2032A, and 6166

When the estate includes stock that qualifies for an IRC §303 redemption and use of a redemption appears at all likely, the estate plan must be evaluated to be certain it does not preclude use of IRC §303.

When a farm operation is split between various entities and, *e.g.,* assets are placed in a corporation to isolate liabilities as well as to provide for redemption, although the ownership may be fractionally transferred to other family members for estate tax reasons, the practitioner must keep in mind the various percentage requirements. In addition to the 3-year rule of IRC §2035, the practitioner must be aware not only of the 50-percent and the 25-percent test of IRC §2032A, but also of the 35-percent test of IRC §§6166 and 303, along with the 20-percent aggregation rules of all three code sections. If some assets are placed in an LLC, which obviously does not qualify for IRC §303 (it is not a corporation), and other assets are placed in a corporation, the LLC assets cannot be combined with the corporate stock to meet either test for IRC §303 purposes.

PRACTICE TIP: The attorney should keep in mind that a redemption is basically tax-free; if there are accumulated earnings, it may be advisable to withhold paying dividends to avoid the 15-percent tax on dividends and to wait for a qualifying death under IRC §303 in order to redeem shares at virtually no tax cost. Even if the money is not used or needed to pay the estate tax and/or IRC §2053 expenses, it allows a tax-free removal of assets from the corporation. On the other hand, if operating assets are in the corporation, and the land, which may be the most valuable asset, is not, the remaining assets in the corporation may not meet the 35-percent test of IRC §303.

If any shares of the corporation, the principal asset of which is farmland, are owned by persons who are not members of the decedent's family (as defined in IRC §2032A(e)(2)), a redemption after the decedent's death will be treated as a disposition of a portion of the farmland to a nonqualified heir, resulting in a partial recapture of tax under IRC §2032A(c). See Rev Rul 85-73, 1985-1 Cum Bull 325.

A qualifying IRC §303 redemption is not treated as a disposition for IRC §6166 purposes. IRC §6166(g)(1)(B). See §3.95. If an election has been made under IRC §6166, the time frame for qualifying redemptions will be the same as under IRC §6166 for the payment of installments. IRC §303(b)(1)(C). Thus, the redemptions can continue for as long as installments are due under IRC §6166.

© The Regents of the University of California

§3.118 J. Midstream Incorporation of Farm

Internal Revenue Code §351 will generally protect nonrecognition of gain when an existing farm converts from a noncorporate form to a corporate form, usually referred to as a midstream incorporation. The main issues, other than the normal pitfalls of IRC §351 (which are beyond the scope of this chapter), include matching income and expenses from the pre-incorporation period with income and expenses of the post-incorporation period. A lack of matching can probably not be avoided, but a continuation of the business after incorporation along the same lines as before incorporation will most likely bode well for the taxpayer if the IRS tries to reallocate income or expenses to a different entity or tax year. The attorney should be aware of an assignment-of-income argument when the owners are trying to divert taxable income away from themselves to a lower bracket taxpayer or to shift tax years, thereby deferring the payment of tax to a later year or years.

© The Regents of the University of California

VI. QUALIFIED CONSERVATION EASEMENTS

§3.119 A. Charitable Deduction Under IRC §§170 and 2055

Generally, for income tax purposes, a charitable deduction under IRC §170 is not allowed for a charitable contribution of any interest in property that consists of less than the donor's entire interest in the property. However, a deduction may be allowed for the value of a qualified conservation contribution. IRC §170(f)(3)(B)(iii).

A qualified conservation contribution is the contribution of (1) a qualified real property interest (2) to a qualified organization (3) exclusively for conservation purposes. IRC §170(h)(1).

The term qualified real property interest means any of the following (IRC §170(h)(2)):

- The entire interest of the donor, other than a qualified mineral interest;
- A remainder interest; or
- A restriction granted in perpetuity on the use that may be made of the real property.

To be eligible for a deduction, the conservation purpose must be protected in perpetuity. IRC 170(h)(5); Reg §1.170A-14(b)(2).

Qualified organizations include (IRC §170(h)(3)):

- The United States, a possession of the United States, a state (or the District of Columbia), or a political subdivision of them, as long as the gift is for exclusively public purposes;
- A domestic entity that meets the general requirements for qualifying as a charity under IRC §170(c)(2) and that generally receives a substantial amount of its support from a government unit or from the general public; and
- A supporting organization as defined in IRC §509(a)(3).

NOTE: For California property tax assessment purposes, the entities authorized to hold conservation easements under CC §815.3 are (1) any state or local government entity and (2) IRC §501(c)(3) organizations that are qualified to do business in California and whose primary purpose is the preservation, protection, or enhancement of land in its natural, scenic, historical, agricultural, forested, or open space condition or use. Rev & T C §402.1.

The term *conservation purposes* means (IRC §170(h)(4)):

- The preservation of land areas for outdoor recreation by, or the education of, the general public;
- The protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem;
- The preservation of certain open space (including farmland and forest land); or
- The preservation of a historically important land area or a certified historic structure.

The donation of a qualified real property interest to preserve open space such as farmland and forest land will meet the conservation purposes test only if such preservation yields a significant public benefit and is either (1) pursuant to a clearly delineated federal, state, or local governmental conservation policy and will yield a significant public benefit, or (2) for the scenic enjoyment of the general public. IRC §170(h)(4)(A)(iii). If the requirements are met, the gift may qualify for an income tax deduction under IRC §170 during life if the easement is created inter vivos, or a charitable estate tax deduction under IRC §2055 if created at death. See *Glass v Commissioner* (6th Cir 2006) 471 F3d 698 (deduction allowed for easements limiting development of portions of lakefront residential property that protect relatively natural habitat).

Additionally, under IRC §2031, the estate may be able to exclude a portion of the value of the underlying land from the gross estate if the required election is made. See §3.120.

NOTE: The creation of a qualified conservation easement under IRC §2055(f) is not a disposition under IRC §2032A. IRC §2032A(c)(8).

© The Regents of the University of California

§3.119A B. Charitable Contribution Limits for Qualified Conservation Easements

Charitable deductions are limited to various percentages of a taxpayer's "contribution base," which is adjusted gross income determined without regard to net operating loss carrybacks. IRC §170(b)(1)(G). The limitations depend on the identity of the donor, the identity of the donee, and the type of property involved. In general, the limitation for a contribution by a corporation is 10 percent. IRC §170(b)(2). The limitation for an individual contributing capital gain property is 30 percent. In most cases, excess contributions can be claimed over a specified number of years in the future. This period is 5 years in the case of a contribution of capital gain property by an individual. IRC §170(b)(1)(C).

For tax years beginning after December 31, 2005, and before January 1, 2008, the Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) raises the otherwise applicable 30-percent limit for contributions of capital gain property by individuals to 50 percent for qualified conservation contributions and allows the deduction to be carried forward for up to 15 years. IRC §170(b)(1)(E), (h)(1). If the donor is a "qualified farmer or rancher," the contribution limit is increased to 100 percent of the excess of the taxpayer's contribution base over the amount of "all other allowable charitable contributions." IRC §170(b)(1)(E)(iv). A qualified farmer or rancher is a taxpayer whose gross income from the trade or business of farming (within the meaning of IRC §2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year. IRC §170(b)(1)(E)(v). See also Notice 2007-50, 2007-25 Int Rev Bull 1430, in which the IRS clarifies when an individual is considered to be a farmer or a rancher and what types of income are included in the individual's gross income from farming for conservation easements made before 2008.

Generally, corporations remain subject to the 10-percent limit, but the 100-percent limit will apply to a corporation that is not publicly traded and that meets the definition of a qualified farmer or rancher for the taxable year in which a qualified conservation contribution is made. IRC §170(b)(1)(E)(iv), 170(b)(2). Any excess may be carried over for 15 years.

Notice 2007-50, 2007-25 Int Rev Bull 1430, also provides guidance on the IRC §170 percentage limitations and indicates that qualified conservation contributions are not taken into account when determining the amount of other allowable charitable contributions (*i.e.,* percentage limitations in IRC §170(b)(1)(A)-(D) apply without regard to contributions described in IRC §170(b)(1)(E)(i)). The qualified conservation contributions are taken into account only after taking into account contributions subject to the percentage limitations in IRC §170.

© The Regents of the University of California

§3.120 C. Estate Exclusion Under IRC §2031(c)

The estate may be able to exclude a portion of the value of the underlying land from the gross estate if all of the following requirements are met (IRC §2031(c)(8)(A)):

- The decedent or a member of the decedent's family has owned the land for the 3-year period ending on the date of the decedent's death.
- No later than the date the election is made, a qualified conservation easement on the land has been made by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust that holds the land.
- The land is located in the United States or one of its possessions.

The qualified conservation easement exclusion also applies if the land is owned indirectly through a partnership, corporation, or trust, if the decedent owned (directly or indirectly) at least 30 percent of the entity. IRC §2031(c)(10).

Similar to the income tax deduction, a qualified conservation easement must be a contribution of (1) a qualified real property interest, in this case, a restriction granted in perpetuity on the use that may be made of the real property; (2) to a qualified organization; and (3) be exclusively for conservation purposes. IRC §§2031(c)(8)(B), 170(h)(1).

If the required election is made, IRC §2031(c) allows for an exclusion from the value of the estate that is limited to the lesser of a fixed dollar amount ($500,000 for 2002 and after) or the applicable percentage set out by statute, which is 40 percent reduced (but not below zero) by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of the easement and reduced by the value of any retained development right). The values taken into account are determined as of the date of the contribution. IRC §2031(c)(1)-(3).

The value of the land must be reduced by the value of any development rights retained by the donor in the conveyance of the easement. Development rights are defined as any right to use the land for any commercial purpose that is not subordinate to and directly supportive of the use of the land as a farm for farming purposes. The reduction is not made if everyone with an interest in the land (regardless of whether in possession) agrees to permanently extinguish the retained development right and the agreement is filed with the return. IRC §2031(c)(5).

© The Regents of the University of California

4

Estate Planning for Vacation Homes

Monica Dell'Osso

I. INTRODUCTION §4.1

II. PLANNING ISSUES §4.2
- A. Ownership §4.3
- B. Limitation of Liability §4.4
- C. Management of Property §4.5
- D. Use of Property §4.6
- E. Maintenance of Property §4.7
- F. Transferability of Interest §4.8

III. PLANNING OPTIONS §4.9
- A. Sale §4.10
- B. Tenancy in Common §4.11
  - 1. Advantages and Disadvantages §4.12
  - 2. Cotenancy Agreement §4.13
- C. Partnership §4.14
  - 1. General Partnership §4.15
  - 2. Limited Partnership §4.16
- D. Limited Liability Company §4.17
- E. Trust
  - 1. Irrevocable Trust §4.18
  - 2. Revocable Trust §4.19
- F. Qualified Personal Residence Trust (QPRT)
  - 1. Overview §4.20
  - 2. Requirements §4.21
  - 3. Disadvantages §4.22
- G. Conservation Easement §4.23
  - 1. Income Tax Deduction §4.24
  - 2. Estate Tax Exclusion and Deduction §4.25

IV. TRANSFER TAX ISSUES §4.26
- A. Retained Interests
  - 1. Right of Possession or Enjoyment Under IRC §2036(a)(1) §4.27
  - 2. Right to Determine Possession or Enjoyment Under IRC §2036(a)(2) §4.28
  - 3. Right to Amend or Revoke Transfer Under IRC §2038 §4.29
- B. Annual Exclusion §4.30
- C. Valuation §4.31
  - 1. Lack of Control Discount §4.32
  - 2. Lack of Marketability Discount §4.33
  - 3. IRS Challenge §4.34

V. REAL PROPERTY TAX ISSUES §4.35

VI. FORMS
- A. Form: Sample Management Procedures §4.36
- B. Form: Sample Vacation Home Trust Provisions §4.37
- C. Form: Sample Lake Home Trust §4.38
- D. Form: Sample Cotenancy Agreement §4.39

© The Regents of the University of California

§4.1 I. INTRODUCTION

Effective estate planning often requires attention not only to the legal and technical issues but also to the emotional and psychological factors underlying the process. These seemingly divergent perspectives are nowhere more apparent than in the context of planning for the succession of a vacation home. In fact, personal family concerns rather than legal or tax-related questions will frequently dominate the discussion.

The estate planning objective almost invariably centers on development of an appropriate strategy for preserving for younger generations a home or property that has been integral to the family history. In many cases, the attachment to this asset stems less from its monetary value than from its significant place in the shared experiences and memories of the family group. It is a place where family members have gathered over the years to enjoy holidays and vacations. It has become a part of the family legacy. Huggins Balfe, Passing It On: The Inheritance and Use of Summer Houses, ix (1999).

This chapter will review the unique constellation of issues that are presented in planning for vacation property. It will discuss various planning options and provide forms for use in this process.

© The Regents of the University of California

§4.2 II. PLANNING ISSUES

A significant part of any transfer strategy is ensuring that the property can be preserved, maintained, and enjoyed in a cooperative and businesslike manner by successive family generations. Selection of the proper mechanism for achieving that objective requires careful analysis of the needs of each family group.

If the vacation property is of significant value, transfer tax considerations will affect the selection of a planning strategy. Fractionalization of ownership to create undivided interests through entity planning or otherwise will allow an opportunity for valuation discounts. If the property is expected to appreciate, a strategy that will freeze the value for transfer tax purposes may be more appropriate.

© The Regents of the University of California

§4.3 A. Ownership

A primary consideration is the manner in which title to the vacation home will be held. One alternative is for the existing owners, usually the parents or senior generation, to retain ownership until their deaths with the property passing at that point to the next generation or to a trust for successive generations. If the property is transferred outright, it is then incumbent on the transferees to enter into a formal agreement regarding ownership and management or to create a partnership, limited liability company, or other entity to hold the property.

The more common arrangement is for the existing owners to form a trust or other entity during their lifetimes and to transfer the property to it. This strategy can provide significant transfer tax benefits while allowing the original owners to maintain control of the property, if appropriate.

Another dimension of the ownership issue is identification of the family members who should ultimately have title and control. Despite the desire of the senior generation to have all the members of successive generations participate in ownership, some individuals may have no genuine interest in the property and will not want to accept any responsibility connected with it. In addition, some members of the next generation may want to participate in ownership, but do not have the financial resources to do so. Although the natural tendency may be for clients to ignore these complexities, hoping that they will somehow be resolved or disappear, the more effective approach is to identify and work through them in the planning process.

© The Regents of the University of California

§4.4 B. Limitation of Liability

It will often be important to structure ownership of the vacation home in a way that shields the owners and the property from liability. One of the family members may experience financial difficulties that could result in judgment liens against the property. If the property is used by or rented to nonowners, there is always the possibility that damage or injury may occur that would lead to a claim. Even with insurance in place, the owners may desire additional protection from personal liability. This particular concern may recommend use of a limited partnership or limited liability company to hold the property.

© The Regents of the University of California

§4.5 C. Management of Property

Structuring an effective mechanism for management of the vacation property is often as important as selecting the form of ownership. Management decisions may be made collectively by all the owners or may be delegated to one individual or a smaller group. If a partnership or limited liability company is utilized, one or more of the partners or members usually will be designated as the manager with the responsibility for making the day-to-day decisions regarding the property. If a trust is the selected entity, the trustee will have the task of managing the property. In a direct ownership situation, ordinarily the owners will have an agreement that designates one or more of them as manager.

In addition to identifying a manager, the agreement or operating document should delineate the authority of that individual and define the issues that are reserved to the owners as a whole. Transfer tax considerations, such as avoidance of a retained interest or control, will have an impact on the selection of a manager and the scope of that individual's authority. When the property is owned by an entity, the applicable statutes and regulations will specify those decisions, such as dissolution, that may require the participation of all owners.

Regardless of these limitations, it is customary in most situations for the more significant issues such as sale of the property to require the approval of all or some plurality of the owners. Those decisions are usually perceived as inappropriate for delegation to a manager.

© The Regents of the University of California

§4.6 D. Use of Property

An important reason for retaining vacation property is to have a place where family members can continue to gather and enjoy time together. Organizing use of the property so that everyone has equal access can be challenging. If the property is suitable only for seasonal use, the available time periods will be limited. Even if the property is usable year round, which is the more common situation in California, there will be times such as holidays and school vacations that will be more desirable and will likely appear on everyone's priority list. If the property is to be rented, the family time becomes even more restricted and the need or desire for revenue must be balanced against the importance of retaining prime usage times for family members.

The solutions to this issue are as varied as the dynamics of each family group. They range from informal arrangements with family members simply agreeing on a yearly or seasonal basis how they wish to divide the available time to a more formal structure that requires each owner to use the property in a manner proportionate to his or her interest. As a way of establishing a pattern for handling this issue, an initial use schedule is sometimes included as part of the co-ownership or entity agreement. Another method is to set the usage allocation by a blind drawing with the order of choice determined by lot. Often a mechanism is included for resolving an impasse if the owners are unable to agree on an equitable arrangement. In some instances, the manager or trustee is given authority to make the final decision.

In addition to addressing a schedule for use of the property, the underlying agreement may also need to outline the limitations and requirements of occupancy. These may include such topics as pets and the condition of the property after use. Although formulation of such rules may seem unduly restrictive, reaching a consensus on them at the outset may eliminate future conflicts, particularly as the family group expands.

Depending on the operational expenses of the property, the owners may be assessed a usage fee. The amount can be determined by the owners collectively or set by the trustee or designated manager if the property is owned by an entity.

© The Regents of the University of California

§4.7 E. Maintenance of Property

Ownership of a vacation property involves ongoing costs. In addition to routine expenses such as mortgage, taxes, and insurance, inevitably there will be expenditures for maintenance, repairs, and improvements. If the property is rented or the owners are assessed a usage fee, at least some portion of the costs can be covered by these funds. However, if the income is insufficient, the financial burden will fall on the owners.

Determining how that responsibility will be handled involves several different questions. One is the decision about which expenditures, other than those for routine costs, should be made. A second is a method of apportioning the approved expenditures among the owners. A third is whether a penalty is imposed for an owner's failure to pay his or her allotted share.

Typically the designated manager or trustee will have authority to make decisions about nonroutine expenditures within certain categories or up to a specified dollar limit. Costs that exceed these parameters require the approval of all or a majority of the owners. Once approved, the expenditures are usually shared by the owners in proportion to their interests. Nonpayment by an owner can produce a range of penalties, including a late charge, a suspension of use rights, or a lien against the owner's interest.

© The Regents of the University of California

§4.8 F. Transferability of Interest

A fundamental premise of planning for vacation homes is that the property remain in the family. Exactly how broadly the family group is defined varies with each situation. However, the common theme is that ownership is restricted to the identified family members.

The co-ownership or entity agreement will routinely include limitations on transfer of an owner's interest during lifetime or at death. These provisions specify the family members who are permissible transferees. Some plans allow transfers only to issue of the original owners with a specific exclusion for collateral relatives or spouses. Other agreements are more expansive. It is customary to allow transfer of an existing owner's interest to a revocable trust for his or her benefit.

Transfer of an interest to a third party or nonpermissible transferee usually is prohibited unless all or a majority of the owners have approved or an offer to purchase has first been made to the other owners or the entity. Under certain plans, failure of the other owners or the entity to acquire the interest will result in sale of the property and termination of the family ownership.

© The Regents of the University of California

§4.9 III. PLANNING OPTIONS

There are a number of options for structuring ownership of a vacation property. They include various forms of outright ownership, a trust, or establishment of a business entity such as a partnership or limited liability company. If the property represents a significant portion of the senior generation's estate and has appreciated in value, transfer tax considerations will have a significant impact on the planning choices. Real property tax issues can also be an important factor. See §4.35.

© The Regents of the University of California

§4.10 A. Sale

If the vacation property has appreciated in value, it may be appropriate to consider a strategy that effects a transfer to successive generations while freezing the value of the property for transfer tax purposes. Techniques such as outright sales, sales to grantor trusts, and grantor retained annuity trusts (GRATs) may be worth considering. However, vacation property ordinarily produces little if any income. For that reason GRATs or sales to grantor trusts are usually inappropriate, because no income stream is available to make the strategy workable. Outright sales to family members may pose similar difficulties. Because the property ordinarily does not generate significant revenue, the children or other family members will have to make payments for the property from their own resources. The family member purchasers, however, may not be in a position to handle such a financial obligation.

An estate freeze strategy that may prove more viable is the Qualified Personal Residence Trust (QPRT). This technique is discussed in more detail in §§4.20-4.22.

© The Regents of the University of California

§4.11 B. Tenancy in Common

A comparatively simple option is to structure ownership of the property as a tenancy in common with each cotenant owning an undivided interest in the property. CC §§685-686. Unlike joint tenancy, there is no requirement that the interests be equal, although that will commonly be the case. The cotenancy arrangement may take several forms. The senior generation may elect to transfer all of its interest in the property to children or grandchildren as tenants in common. Alternatively, the senior generation may decide to transfer only fractional interests in the property while retaining partial ownership.

© The Regents of the University of California

§4.12 1. Advantages and Disadvantages

If the senior generation transfers all of its interest, it will lose control of the property. That strategy is appropriate if the senior generation has ceased to use the property and wants to relinquish responsibility for its management. If the senior generation wants to continue its involvement with the property, a partial ownership transfer may be more palatable.

Depending on the value of the property and the number of donees, transfer of the senior generation's entire interest may be a reportable gift that will require use of some portion of the transferor's applicable exclusion amount or the payment of gift tax. Transfer of partial interests provides the opportunity for discounted gifts. It also fractionalizes the interest of the transferor, thereby allowing an opportunity for discounting at the time of the transferor's death.

© The Regents of the University of California

§4.13 2. Cotenancy Agreement

The cotenants will usually want to enter into a formal agreement regarding operation of the property. The agreement will remain in effect for a term of years or until occurrence of a specific event such as the death of the surviving owner or sale of the property to a third party.

The agreement should address such issues as day-to-day management, financial contributions of the owners, improvement and maintenance, use and rental of the property, and transfer of interests. In a typical arrangement, routine decisions about the property are delegated to an owner-manager, while significant issues such as capital improvements are left to the collective approval of the owners. The manager position is usually filled on a rotating basis or is subject to a specified term. It is advisable to include a provision for resolution of disputes by arbitration or some other alternative method. A resort to litigation is not only costly, but could be destructive to family harmony and relationships.

A tenant in common has the right to petition the court for partition of his or her interest. CCP §§872.210, 872.710. That could result in a forced sale of the property at a substantially discounted price. In addition to the negative impact on the family relationship, a partition action will mean substantial economic loss to the owners. To prevent that development, it is important to include in the agreement a waiver by the cotenants of their right to partition.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/4 Estate Planning for Vacation Homes/§4.14 C. Partnership

§4.14 C. Partnership

Creation of a general partnership is an alternative for collective ownership of the vacation property. Instead of entering into a cotenancy agreement, the owners could elect to form a partnership as a way of managing and operating the asset. Depending on the overall objective, a partnership could be established by the senior generation jointly with the transferees of the property or by the transferees alone if the senior generation relinquishes its entire interest.

There is one potential issue with using a partnership in planning for vacation homes. A partnership, whether general or limited, is specifically defined as an association to carry on "a business for profit." Corp C §§16101(1), 16202(a). Because a vacation property is rarely held for the purpose of carrying on a business and generating revenue, ordinarily it will be difficult to satisfy the statutory requirement for a partnership. The partnership agreement typically will include a provision that defines a broad business purpose for the enterprise. However, if the entity is challenged by the IRS, which could occur if the entity is being used as a means of making discounted gifts, a demonstration that the enterprise satisfies the "for profit" requirement may be problematic.

© The Regents of the University of California

§4.15 1. General Partnership

General partnerships formed under California law are governed by the Uniform Partnership Act of 1994 (Corp C §§16100-16962). This statute is generally known by the acronym RUPA (Revised Uniform Partnership Act). Under RUPA, a partnership is considered an entity distinct from its partners. Corp C §16201.

In a general partnership, each of the partners is an agent of the partnership and can bind the partnership in the ordinary course of business. Corp C §16301(1). Each of the partners has an interest in the partnership proportional to his or her contribution. Corp C §16401. Although title to the property is held in the partnership name, any partnership profits or losses are allocated among the partners in those same proportions. Liability is not limited; all partners are individually liable for any obligations of the partnership. Corp C §16306. The partnership may be dissolved by the express will of at least half of the partners, regardless of any written agreement to the contrary. Corp C §16801(1). Ordinarily a general partnership is not subject to federal income tax or California income or franchise tax. IRC §§701-777; Rev & T C §§17851-17865. On income taxation of partnerships, see generally Advising California Partnerships, chap 8 (3d ed Cal CEB 1999).

The partnership agreement addresses the operation of the entity. The issues covered in the agreement include designation of a managing partner and the scope of his or her authority, use and operation of the property, and transfer of interests. The agreement also specifies the term of the partnership. Typically it exists for a period of years or until a definite event such as liquidation or dissolution.

Transfers of partnership interests are eligible for valuation discounts because they constitute only a partial interest in the entity. However, the discounts are not as significant as those available for transfers of interests in a limited partnership or limited liability company.

On forming a general partnership, see generally Advising California Partnerships, chap 4.

© The Regents of the University of California

§4.16 2. Limited Partnership

Another alternative for ownership of vacation property by multiple owners is creation of a limited partnership. Limited partnerships are governed by the California Revised Limited Partnership Act (CRLPA) (Corp C §§15611-15723) and the Limited Partnership Act of 2008 (Re-RULPA) (Corp C §§15900-15912.07). Re-RULPA applies to existing limited partnerships that elect to be covered by its provisions after January 1, 2007, limited partnerships formed after January 1, 2008, and all limited partnerships after January 1, 2010. Corp C §15912.06.

A limited partnership is a partnership with one or more limited partners and one or more general partners. Corp C §15901.02(q) (Corp C §15611(r) for nonelecting limited partnerships until January 1, 2010; Corp C §15724). Limited partners do not participate in the control of the entity and are not personally liable for the obligations of the partnership. Corp C §§15903.02-15903.03 (Corp C §15632 for nonelecting limited partnerships until January 1, 2010; Corp C §15724). The general partners are actively engaged in management and control of the entity and have unlimited personal liability for its obligations. Corp C §§15904.02-15904.06 (Corp C §15643 for nonelecting limited partnerships until January 1, 2010; Corp C §15724). Limited partnerships usually choose to be taxed as partnerships (not as corporations). As a result, they are generally not subject to federal or California income tax. They are, however, subject to a state franchise tax. IRC §§701-707; Rev & T C §17851-17857.5, 17935-17936, 23153. See also §§1.6-1.8; Advising California Partnerships §§5.9-5.11 (3d ed Cal CEB 1999).

Because the ownership interests in the entity are not equal but are bifurcated into general and limited interests with different attributes, the limited partnership is more commonly created by the senior generation, which utilizes it as a mechanism to operate the property and transfer interests to other family members. The senior generation contributes the property to the partnership in exchange for general and limited partnership interests. Subsequently some or all of the limited partnership interests are transferred to other family members. Because the limited partners have only a fractional interest with restricted rights and no control of the entity, the gifts are eligible for a valuation discount.

If the economics of the family permit, the limited partnership interests can be purchased rather than gifted. The members who are to receive the interests contribute a specified amount to the partnership in exchange for receipt of an interest.

In addition to the transfer tax advantages, the limited partnership affords the senior generation an opportunity to remain in control of the entity. By retaining the general partnership interest, this generation is able to continue management and operation of the vacation property. As discussed in §§4.27-4.29, the decision to remain in control needs to be structured in a manner that does not risk inclusion of the partnership in the estates of the senior generation.

The written partnership agreement defines the business purpose of the partnership and the term of the entity and delineates the regulations for its operation. It also addresses such issues as day-to- day management, improvements and maintenance, use of the property, and transfer of interests.

On forming a limited partnership, see generally Advising California Partnerships, chap 5.

© The Regents of the University of California

§4.17 D. Limited Liability Company

An entity that has gained particular favor in recent years is the limited liability company (LLC). Unlike a partnership, an LLC does not require a "for profit" purpose. It is, therefore, particularly useful for ownership of a vacation property.

The requirements for establishment and operation of an LLC are set forth in the Beverly-Killea Limited Liability Company Act. Corp C §§17000-17655. The members of an LLC do not have personal liability for the debts and obligations of the entity. Corp C §17101. An election can be made to tax the entity as a partnership for federal income tax purposes. Reg §§301.7701-1—301.7701-3. Consequently, it offers one of the more desirable characteristics of corporate ownership without the disadvantage of double taxation of earnings. However, an LLC in California must pay an annual franchise tax of $800, plus a statutory fee for any year in which the LLC's total income, *i.e.,* gross revenues, is $250,000 or more. Rev & T C §§17941-17943, 23153(d)(1).

Similar to a limited partnership, the LLC has significant estate planning advantages. It offers the opportunity to fractionalize ownership by making discounted gifts of interests in the entity. The LLC is typically created by the senior generation, which contributes the vacation property to the entity. At the outset, senior generation members are the only members of the LLC and its initial managers. Interests in the LLC can then be transferred to other family members. Depending on the rights accorded to the nonmanager members, the transfers will be eligible for valuation discounts. The interest that remains in the hands of the senior generation is similarly eligible for discounts for estate tax purposes.

The LLC operating agreement sets forth the requirements for operation of the entity and the transferability of interests. It also routinely includes provisions regarding management, maintenance, and use of the property owned by the entity.

On limited liability companies in general, see Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007). See also §1.9.

NOTE: A useful planning structure, but one that may be overly complex for vacation home planning, is to create an LLC to serve as general partner of a limited partnership. This has the benefit of providing liability protection for the general partner.

© The Regents of the University of California

E. Trust

§4.18 1. Irrevocable Trust

The senior generation can elect to transfer ownership of the property to an irrevocable trust. A significant disadvantage to this approach is that the transfer will be a taxable gift. Unless the transfer is limited to a partial interest, there would be no opportunities for discounting the value of the gift. If the senior generation does not want to make inter vivos gifts of property interests to younger family members and the primary objective is to preserve the property for successive generations, an entity such as a limited partnership or LLC would probably be of little value. In these circumstances, transferring the vacation property to a trust on the death of the senior generation owners may be the appropriate strategy.

Regardless of when the trust is established, the usual plan is that it continues in existence after the owner's death with sufficient funds to maintain the property for some period of time. The property is available to designated family members who are the beneficiaries of the trust. The trustee has the authority to make decisions regarding management and use of the property, perhaps in consultation with the beneficiaries. The trust terminates after a term of years or on the occurrence of specified events such as sale of the property or discontinuation of use by the family. On termination, the property or the remaining assets of the trust are distributed to the beneficiaries. On the potential for inclusion in the settlor's estate if, on creation, the settlor retains broad discretion with respect to beneficiary distributions, see §4.29.

On irrevocable trusts in general, see Drafting California Irrevocable Trusts (3d ed Cal CEB 1997).

© The Regents of the University of California

§4.19 2. Revocable Trust

A revocable trust may be an option for ownership of the vacation property by multiple owners. If title to the property is held by several family members, they may elect to create a trust as a means of handling management and operation of the asset. In this sense, it would be an alternative to a cotenancy agreement or a general partnership. An advantage of the revocable trust over either of these arrangements is that it avoids probate on transfer of a deceased beneficiary's interest. On the potential for inclusion in the settlor's estate, see §4.29.

On revocable trusts in general, see Drafting California Revocable Trusts (4th ed Cal CEB 2003).

© The Regents of the University of California

F. Qualified Personal Residence Trust (QPRT)

§4.20 1. Overview

A qualified personal residence trust (QPRT) can be an effective strategy for transferring vacation property at a reduced transfer tax cost. A QPRT is an irrevocable trust established for a term of years to hold an interest in residential property. The settlor retains the right to occupy the property during the term of the trust. IRC §2702(a)(3)(A)(ii). When the trust terminates, the property passes to the designated beneficiaries.

A QPRT operates as an estate-freezing device. The value of the residence for gift tax purposes is its discounted value at the time of its transfer to the trust. All appreciation is removed from the settlor's estate. A discounted value is available because a QPRT constitutes one of the authorized exceptions to the zero valuation rule of IRC §2702. Reg §25.2702-5(a). Internal Revenue Code §2702 provides that the value of a transfer is determined by subtracting the value of the transferor's retained interest from the value of the property transferred and assigning a zero value to the retained interest. The statute applies to any transfer of an interest in trust to a family member of the transferor. IRC §2702(c)(2), (e). However, because IRC §2702 does not apply to a QPRT, transfers to that entity will be valued by subtracting the value of the transferor's retained interest, which is a number other than zero, from the total value of the property. The resulting number is the value of the remainder interest that passes to the designated beneficiaries and is the amount of the reportable gift on creation of the QPRT.

For a more extensive discussion of QPRTs, see California Estate Planning §§25.29-25.30 (Cal CEB 2002) and Drafting California Irrevocable Trusts, chap 17 (3d ed Cal CEB 1997). On calculating the value of a QPRT gift in particular, see Irrevocable Trusts §17.24.

© The Regents of the University of California

§4.21 2. Requirements

The requirements and permissible terms of a QPRT are set forth in Reg §25.2702-5(c). The trust is prohibited from owning any asset other than the personal residence of the settlor (except for reasonable amounts of cash for operating expenses). A personal residence is defined as the principal residence of the settlor, one other residence, or an undivided fractional interest in either. Reg §25.2702-5(c)(2)(i). Therefore, a settlor can establish QPRTs for both a personal residence and a vacation home, but not for two vacation homes.

A personal residence includes appurtenant structures used for residential purposes and adjacent land not in excess of what is reasonably appropriate for residential purposes, taking into account the size and the location of the residence. It does not include tangible personal property such as household furnishings. Reg §25.2702-5(c)(2)(ii).

Numerous Private Letter Rulings have commented on the circumstances under which additional land and structures will be considered part of a personal residence. The IRS has been comparatively lenient in determining the amount of additional land that would be considered appropriate. See, *e.g.,* IRS Letter Rulings 9442019 (distinct lots of land used for 23 years as one ten-acre homestead and having no separate road access held to constitute adjacent land) and 9503025 (two lots on opposite side of street from family vacation home continuously used for 30 years for family activities and to protect access to and view of bay considered adjacent land). See also IRS Letter Rulings 9741004, 9639064, and 9544018 (approving QPRTs on lots of four, 43, and 18 acres, respectively).

Rulings that have approved additional buildings as part of the personal residence involved structures such as guest houses and garage apartments that were small relative to the main dwelling and related to the residential use. See, *e.g.,* IRS Letter Rulings 200626043 (improvements consisting of vacation home with five bedrooms and five baths, detached three-car garage, artist studio, and "bunk house"), 200241039 (parcel containing vacation residence, guest house, barn, boathouse, two sheds, and large pier and dock), 200126026 (parcel consisting of house, barn, storage shed, and garage), 199918049 (parcel including residence, tennis cottage, and caretaker's house), and 9730013 (parcel including guest house, barn, two storage buildings, and indoor riding barn). See also McCaffrey & Schneider, *GRAT and QPRT Planning,* Estate Planning 2002, chap 5 (Cal CEB 2002).

The residence must be used primarily as a residence. It can be rented during the time that it is occupied by the settlor. However, the rental cannot exceed the period that would cause the residence to cease to be a personal residence under IRC §280A(d)(1). Reg §25.2702-5(c)(2)(i)(B). Therefore, the settlor's personal use of the residence must be for the greater of 14 days or 10 percent of the number of days during which the property is rented. If the settlor ceases to use the property, it will continue to qualify as a residence provided it is held for use by the settlor. A residence is held for use as long as it not occupied by any other person (other than a spouse or dependent of the settlor) and is available at all times for use by the settlor. Reg §25.2702-5(c)(7)(i). This requirement may pose a problem with use of a QPRT for the senior generation's interest in vacation property, particularly if the adult, non-dependent children or other family members have the right to occupy the property at specified times during the year.

The regulations authorize funding a QPRT with a fractional interest in a personal residence. Reg §25.2702-5(c)(2)(i)(C). Although a settlor can transfer only two residences to a QPRT or QPRTs, there is no limit to the number of QPRTs that can be created. Therefore, a settlor could establish multiple trusts with a single vacation property. If the property is owned by a husband and wife as community property, it is usually preferable to establish a separate QPRT for each spouse's interest. The use of multiple QPRTs will allow a fractional interest discount on funding. See, *e.g., Estate of Alto B. Cervin,* TC Memo 1994-550, rev'd on other grounds (5th Cir 1997) 111 F3d 1252; *Samuel J. LeFrak,* TC Memo 1993-526; *Estate of Anthony J. Frank*, *Sr.,* TC Memo 1995-132. Also, setting up trusts with different terms for each fractional interest will reduce the survival risk of a single QPRT. See §4.22 on disadvantages of QPRTs.

Additions of cash held in a separate account can be made to a QPRT for payment of trust expenses (including mortgage payments) and improvements. However the expenditures for the designated purposes must be made within six months of receipt of the contributions. Reg §25.2702-5(c)(5)(ii)(A). On the use of mortgaged property, see IRS Letter Ruling 9340009; Drafting California Irrevocable Trusts §17.5 (3d ed Cal CEB 1997).

© The Regents of the University of California

§4.22 3. Disadvantages

There are several disadvantages to a QPRT that should be carefully evaluated before a decision is made to use this technique. If the settlor dies during the term of the QPRT, the full value of the property is included in the settlor's gross estate under IRC §2036. If the applicable exclusion amount was used at the time of creation of the QPRT it will be restored, thereby mitigating the adverse tax consequences of inclusion of the property. However, the settlor will have lost the opportunity to use an alternative strategy to escape tax on the increase in the value of the property between the date of the transfer and the date of death.

A second problem is the loss of a new tax basis for the property on the settlor's death. On termination of the QPRT, the beneficiary receives a carryover basis in the property. If the beneficiary had received the property on the death of the settlor, the basis would have been stepped up to fair market value. IRC §1014. At one time the settlor was able to avoid this result by repurchasing the residence shortly before expiration of the trust. That strategy has been eliminated by Reg §25.2702-5(c)(9), which requires that the governing instrument include a provision prohibiting sale or transfer of the residence to the settlor.

A third issue, which can be of particular significance with respect to a vacation property, is the settlor's loss of use of the residence after the QPRT terminates. If the settlor continues to occupy the property after the trust ends, he or she will be regarded as having retained an interest in the property that will cause inclusion in his or her estate under IRC §2036. In several Letter Rulings, however, the IRS has taken the position that continued occupancy will not result in estate tax inclusion if the settlor pays fair market rent. See, *e.g.,* IRS Letter Rulings 200822011, 9735011, 9626041, 199931028.

A QPRT is not an effective tool for generation-skipping transfers because no GST tax exemption can be allocated to a QPRT until expiration of the period during which the transferred property would be included in the settlor's estate. IRC §2642(f). In the case of a QPRT, this "estate tax inclusion period" or ETIP will not end until the termination of the QPRT (or the settlor's death, if earlier). If a transfer is made to a grandchild at termination of the QPRT, a generation skip will occur with the result that the GST exemption will have to be allocated to the entire value of the property transferred. There is no opportunity for leveraging the exemption as would have occurred if an allocation had been made at the time of creation of the QPRT.

As a result of the ETIP rule, it is usually advisable to limit the remainder beneficiaries of a QPRT to children and provide makeup gifts to the grandchildren from another source. Unfortunately, that plan may not work particularly well in the context of a vacation property if there is a desire to transfer ownership to younger generations. One possible strategy is to create a separate QPRT for each child with each trust owning a fractional interest in the property. If a child dies, it would be necessary to allocate GST exemption only to the portion of the property in that child's trust. Unfortunately, fractionalizing ownership of the vacation property among several trusts will add significant complexity to management of the property.

© The Regents of the University of California

§4.23 G. Conservation Easement

In some instances, a vacation property may include open spaces or a wildlife or other natural habitat that should be preserved. Use of a conservation easement may be appropriate in those cases. If the property qualifies, the preservation goal can be accomplished with significant income and estate tax benefits. Although the conservation easement does not directly address the issues related to retention of the vacation property by the family, tax savings provided by this strategy may enable the family group to continue to hold the property.

© The Regents of the University of California

§4.24 1. Income Tax Deduction

Internal Revenue Code §170 allows an income tax deduction for a "qualified conservation contribution." The contribution must be of a qualified real property interest to a qualified organization exclusively for conservation purposes. IRC §170(h)(1). A qualified real property interest is either the donor's entire interest in the property, a remainder interest, or a perpetual restriction on use of the property, *i.e.,* a conservation easement. IRC §170(h)(2); Reg §1.170A-14(b)(2). A qualified organization is either the United States, a U.S. possession, a state (or the District of Columbia), or a political subdivision of either of them, or a qualifying publicly supported charity or a supporting organization. IRC §170(h)(3).

NOTE: For property tax assessment purposes, CC §815.3 limits the entities authorized to hold conservation easements to (a) any state or local government entity and (b) IRC §501(c)(3) organizations that are qualified to do business in California and whose primary purpose is the preservation, protection, or enhancement of land in its natural, scenic, historical, agricultural, forested, or open space condition or use. Rev & T C §402.1.

A conservation purpose is defined as preservation of land for outdoor recreation or education of the general public; protection of a natural habitat for fish, wildlife, or plants; preservation of open space; or preservation of an historically important land area or certified historic structure. IRC §170(h)(4). A contribution is treated as exclusively for conservation purposes only if the conservation purpose exists in perpetuity. IRC §170(h)(5).

The process of determining the value of the contribution can be complex. The regulations define the value of the contribution as the fair market value of the perpetual conservation restriction at the time of the contribution. Reg §1.170A-14(h)(3). In most circumstances, if no comparable sales are available, the usual measure of the fair market value of the conservation easement is the difference between the fair market value of the property before the grant of the easement and the fair market value of the property after the restriction has been imposed. The income tax charitable deduction available for the contribution is subject to the percentage limitations that apply to charitable deductions generally. IRC §170(b)(1). A detailed discussion of those requirements is beyond the scope of this chapter. See §§3.119A, 7.13-7.18. See also California Estate Planning, chap 23 (Cal CEB 2002).

NOTE: Use of a conservation easement in combination with a QPRT can provide some significant planning benefits. If the easement is put in place before creation of the QPRT, the result may be a reduction in the value of the remainder interest and allowance of a shorter term for the QPRT. See Henderson & Caverly, *Family Vacation Homes: Planning with Qualified Conservation Contributions,* 14 Cal Trusts & Estates Q 25, 32 (Winter 2008).

© The Regents of the University of California

§4.25 2. Estate Tax Exclusion and Deduction

For estates of decedents dying after December 31, 1997, the personal representative can elect to exclude from the gross estate up to 40 percent of the value of any "land subject to a qualified conservation easement." IRC §2031(c)(2). A qualified conservation easement is defined as preservation of land for outdoor recreation or use as a natural habitat, or preservation of open space for scenic enjoyment. Unlike a qualified conservation contribution under IRC §170, for estate tax exclusion purposes a qualified conservation easement does not include preservation of historically important land or certified historical structures. IRC §2031(c)(8)(B).

The conservation easement may be created before or after death. However, the election must be made on or before the due date for filing of the estate tax return, including extensions. IRC §2031(c)(6). See IRS Letter Ruling 200418005 (postdeath contribution of scenic easement qualified for estate tax exclusion). The amount excluded is the lesser of:

- The applicable percentage as defined in IRC §2031(c)(2), reduced by the amount of the charitable deduction for a contribution of land exclusively for conservation purposes under IRC §2055(f); or
- The exclusion limitation (IRC §2031(c)(1)(A)).

The applicable percentage under IRC §2031(c)(2) is 40 percent reduced (but not below zero) by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land. The applicable percentage is determined by using the date of contribution value (without regard to the easement) and is applied to the value of the property as of the date of death (or alternate valuation date) after the easement has been put in place. IRC §2031(c)(2). The exclusion limitation is $500,000 for decedents dying in 2002 and later. IRC §2031(c)(3).

The exclusion does not apply to the extent that the land is debt-financed property (IRC §2031(c)(4)), nor does it extend to the value of any retained development rights (IRC §2031(c)(5)). However, if the persons having an interest in the land execute an agreement to extinguish the development rights on or before the date the estate tax return is due, the estate tax is reduced accordingly. IRC §2031(c)(5).

The land subject to the easement must have been continuously owned by the decedent or the decedent's family members during the 3-year period prior to the decedent's death. IRC §2031(c)(8)(A)(ii). The easement must have been created by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust that owns the land intended for the easement. IRC §2031(c)(8)(A)(iii). The exclusion is available for land held by a partnership, corporation, or trust, if at least 30 percent of the entity is owned directly or indirectly by the decedent. IRC §2031(c)(10). There is no mention in the statutes of ownership by an LLC.

In addition to an exclusion from the value of the gross estate, IRC §2031(c) also provides an unlimited deduction for the value of a conservation easement that would otherwise qualify for a deduction under IRC §2055(f). This deduction applies even to easements contributed *after* death. The contribution must be made on or before the due date for filing the estate tax return, including extensions. The only limitation is that the same contribution may not be used as a deduction for income tax purposes. IRC §2031(c)(9).

EXAMPLE: Assume that vacation property is worth $2 million at the time of the death of the senior generation owner. If the executor makes a timely contribution of a conservation easement worth $1 million, the estate would receive a deduction in that amount. (No income tax deduction is available for the contribution.) In addition, the estate is eligible for the limited exclusion available under IRC §2031(c). On these facts, the deduction would be the lesser of 40 percent of the value of the property after deduction of the value of the easement, or $500,000. In this example the smaller figure would be 40 percent of the discounted value of the property or $400,000. Therefore the value of the property in the estate would be reduced to $600,000.

© The Regents of the University of California

§4.26 IV. TRANSFER TAX ISSUES

Although nontransfer tax issues will often dominate the discussion about planning for vacation homes, they are not the only factors affecting decisions. Particularly if the property has significant value and is expected to appreciate in the future, transfer tax considerations will be important.

© The Regents of the University of California

A. Retained Interests

§4.27 1. Right of Possession or Enjoyment Under IRC §2036(a)(1)

A taxpayer's estate will include the value of property transferred during life, by trust or otherwise, if the taxpayer retains a right of possession or enjoyment of the property. IRC §2036(a)(1). This rule can pose a problem when the senior generation transfers the vacation home directly to other family members or to a limited partnership or LLC, but wishes to retain the right to use the property. The same issue can arise in connection with a QPRT when the settlor continues to occupy the property after termination of the trust. See §4.22.

In most vacation home situations, the entire interest in the vacation home property is not transferred. More often a partial interest is transferred to create a cotenancy, or the property is contributed to an entity, partial interests in which are subsequently gifted to other family members. A co-ownership or partial ownership arrangement has not necessarily prevented inclusion of the entire property in the donor's estate. Rev Rul 78-409, 1978-2 Cum Bull 234; *Estate of Rapelje* (1979) 73 TC 82. However, if the donor's possession or occupancy is limited to a particular time segment or a certain part of the property, there may be a basis for limiting inclusion to that portion. Rev Rul 79-109, 1979-1 Cum Bull 297.

If the entire vacation property is transferred and the donor wishes to continue to use the property, the safest approach is to pay fair market rent to the transferees or a trust for their benefit. In the more common situation involving only a partial transfer, the organizational or operating document should provide for usage on a basis proportional to the ownership interests.

© The Regents of the University of California

§4.28 2. Right to Determine Possession or Enjoyment Under IRC §2036(a)(2)

Even if the transferor does not retain the right to possession or enjoyment of the property, he or she is treated as retaining an interest if he or she has the right, either alone or in conjunction with another person, to determine possession or enjoyment of the property. IRC §2036(a)(2). Therefore, if the senior generation members contribute the vacation property to a limited partnership and retain the right as general partners to control distribution of income to the other partners, they are regarded as having retained an interest in the property that will result in its inclusion in their estates.

The provisions of IRC §2036(a)(2) pose a particular problem for family limited partnerships and LLCs. When creating these entities for vacation homes or other family assets, the senior generation routinely occupies the position of general partner or member-manager. The motivation for this arrangement is a desire by that generation to exercise control over the entity.

In several Letter Rulings, the IRS has concluded that if a general partner, or by analogy a member-manager, is subject to a fiduciary duty to the limited partners (or nonmanager members) under state law, the management authority that he or she holds will not be deemed a retained power that will cause inclusion of the transferred asset in the general partner's estate under IRC §2036(a)(2). This principle applies even if the general partner has the right to retain income in the entity for business purposes. See, *e.g.,* IRS Letter Rulings 9131006, 8611004, 9710021, 9415007. But see *Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II)*. See §§1.37, 4.34.

California imposes a fiduciary duty on general partners and member-managers that governs their conduct with respect to limited partners and nonmanager members, respectively. Corp C §§15643, 16404, 17153. However, that duty should also be clearly set forth in the partnership or LLC operating agreement.

© The Regents of the University of California

§4.29 3. Right to Amend or Revoke Transfer Under IRC §2038

Under IRC §2038, property will be included in a transferor's estate if he or she retains the right to alter, amend, revoke, or terminate the transfer.

The issue of retained rights under IRC §2038 can be a problem in the context of a trust. A revocable trust in which the settlor has retained the right to amend, revoke, or terminate is includible in the settlor's estate. As discussed in §4.19, a revocable trust sometimes may be used by multiple owners of a vacation property as a substitute for a co-ownership arrangement. However, in that context the ownership arrangement is typically motivated by practical concerns related to management of the property with transfer tax planning of only secondary importance.

Even if the strategy involves creation of an irrevocable trust (see §4.18), IRC §2038 must be carefully considered. Although the settlor may have no power to amend or revoke the trust, certain provisions could result in the settlor being deemed to have an indirect power to alter the beneficial interests. For example, if a settlor-trustee has broad discretion with respect to beneficiary distributions, IRC §2038 will apply to cause inclusion of the trust in the settlor's estate.

© The Regents of the University of California

§4.30 B. Annual Exclusion

One of the primary objectives in creating a limited partnership or LLC for ownership of a vacation property is to take advantage of the gift tax annual exclusion in order to transfer interests in the entity to younger generation family members. The annual exclusion allows an individual to transfer $13,000 (adjusted annually for inflation) to an unlimited number of donees each year. IRC §2503(b)(1); Rev Proc 2009-50, 2009-45 Int Rev Bull 652; Rev Proc 2008-66, 2008-45 Int Rev Bull 1107. A husband and wife jointly may transfer $26,000 to each donee. Reg §25.2513-1(c).

To qualify for the annual exclusion, the transfer must give the donee a present interest in the property. IRC §2503(b); Reg §25.2503-3. Whether a transfer of an interest in a limited partnership or LLC constitutes a present interest depends on the facts and circumstances of each case. The IRS has determined that a gift of a limited partnership interest did not qualify for the annual exclusion when the general partner had sole discretion to determine income distributions and the limited partners had no right to transfer their interests. IRS Letter Ruling 9751003. See also *Christine M. Hackl* (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664. However, IRS Letter Rulings 9131006, 8611004, 9710021, and 9415007, discussed in §4.28, held that if the general partner (or member-manager) has a fiduciary duty to the limited partners (or nonmanager members), retention by the general partner (or member-manager) of discretionary authority with respect to distributions will not jeopardize the annual exclusion.

It is less clear whether, as an additional requirement, the donees must have the ability to transfer their interests to a third party. This latter issue is of particular significance in the context of the family partnership or LLC established for a vacation property. Generally the senior generation will want to restrict transfers of interests to unrelated third parties and perhaps even to some related persons such as in-laws. The concern is that ownership of the entity and the property remain within a defined family group. In several Letter Rulings, the IRS has noted that a limited partner's right to assign his or her interest to a third party after first offering it to the other partners was a basis for recognizing the limited partner's interest as a present interest. IRS Letter Rulings 9710021, 9415007, 9131006, 8611004.

AUTHOR'S ADVICE: It appears that the most prudent approach is to give a limited partner or a nonmanager member the right, in the partnership or LLC operating agreement, to assign his or her interest after first offering it to the entity or the other owners. As a practical matter, such a provision is unlikely to create a problem. There are few, if any, third parties interested in purchasing an interest in a family-owned entity and certainly none who would be willing to pay any significant amount for the asset.

© The Regents of the University of California

§4.31 C. Valuation

An important reason to fractionalize ownership of a vacation property is to take advantage of reductions in the value of the transferred interests through the use of discounts. In the context of the vacation home, the commonly available discounts are for lack of control and lack of marketability. The discount for lack of control will ordinarily be available in connection with transfers of interests in entities such as limited partnerships and LLCs. However, it may also be applicable to outright transfers of fractional interests in property.

The same reductions in value will be available at the time of the original property owner's death. If, as the result of transfers made during his or her lifetime, the original owner at death holds only a partial interest in the vacation property or the entity to which the property was transferred, that remaining interest may be eligible for valuation discounts.

Valuation of property for federal estate and gift tax purposes is a question of fact. The standard is the fair market value of the asset as of the date of death or the date of transfer. IRC §§2031(a), 2512(a). The regulations define fair market value as the price at which the property would change hands between a willing buyer and a willing seller, neither of whom is under any compulsion to sell and both of whom have reasonable knowledge of relevant facts. Reg §§20.2031-1(b), 25.2512-1. Because each parcel of real property, the asset typically involved in vacation home planning, is unique, valuation must be determined in accordance with the facts and circumstances of the particular situation. Market activity, local sales, rentals, and replacement cost are factors that may be considered in determining value.

For further discussion of valuation discounts, see §§1.14-1.18.

© The Regents of the University of California

§4.32 1. Lack of Control Discount

A lack of control discount, also referred to as a minority interest discount, is appropriate when valuing a partial interest in an asset that does not provide the holder with the right to make decisions regarding disposition of the asset or other issues. It applies to a minority interest in an entity such as a limited partnership or LLC and, by analogy, to a fractional interest in real estate. Because the minority owner does not have sufficient control to direct decisions, a minority interest has a lesser value than a controlling interest in the entity or the asset. Rev Rul 59-60, 1959-1 Cum Bull 237.

With respect to real property, the IRS has resisted substantial discounts based on lack of control, arguing that the discount should be limited to the expected costs of partition. IRS Letter Ruling 9336002. However, several Tax Court decisions issued since the release of the Letter Ruling have questioned this approach. *Samuel J. LeFrak,* TC Memo 1993-526; *Estate of Alto B. Cervin,* TC Memo 1994-550, rev'd on other grounds (5th Cir 1997) 111 F3d 1252; *Estate of Ellie B. Williams,* TC Memo 1998-59; *Estate of John L. Baird,* TC Memo 2001-258. In *Baird,* the Tax Court allowed a 60-percent discount for undivided fractional interests in a trust that owned timber property.

© The Regents of the University of California

§4.33 2. Lack of Marketability Discount

A lack of marketability discount takes into the account the fact that there is no ready market for interests in a closely held entity or fractional interests in real property. Sale of such interests to anyone other than the owner group, which is usually limited to family members, is extremely difficult. This factor becomes even more significant when, as is commonly the case, the operating agreement contains limitations on the transferability of interests in the entity. *Samuel J. LeFrak,* TC Memo 1993-526; *Estate of Alto B. Cervin,* TC Memo 1994-550, rev'd on other grounds (5th Cir 1997) 111 F3d 1252; *Ina F. Knight* (2000) 115 TC 506. See also §1.15.

© The Regents of the University of California

§4.34 3. IRS Challenge

In recent years, the IRS has mounted serious challenges to family limited partnerships and other closely held entities. Initially, the attack focused on the validity of the entity or the amount of the valuation discount. More recently, the IRS has argued with some success that the property transferred to an entity is includible in the transferor's estate under IRC §2036(a)(1)-(2), based on the rationale that the decedent retained an interest in or enjoyment of the assets after their contribution to the entity. As a result, the assets, rather than the decedent's interest in the entity, are included in the decedent's estate with a corresponding loss of any valuation discounts. *Estate of Bigelow v Commissioner* (9th Cir 2007) 503 F3d 955; *Estate of Albert Strangi*, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 *(Strangi II)*; *Estate of Wayne C. Bongard* (2005) 124 TC 95; *Estate of Emma V. Jorgensen,* TC Memo 2009-66; *Estate of Hilde E. Erickson,* TC Memo 2007-107; *Estate of Theodore R. Thompson,* TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367; *Estate of Morton B. Harper,* TC Memo 2002-121; *Estate of Dorothy Morganson Schauerhamer,* TC Memo 1997-242.

Under IRC §2036(a), a retained interest will not cause inclusion in the estate if the transfer in question was the result of a "bona fide sale for an adequate and full consideration in money or money's worth." The bona fide sale exception is met when the "record establishes a legitimate and significant nontax reason for creating the family limited partnership and the transferors received partnership interests proportionate to the value of the property transferred." *Estate of Wayne C. Bongard* (2005) 124 TC 95, 118. The determination is made based on "objective" evidence, not the subjective intent of the transferor. *Estate of Albert Strangi*, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*). The Ninth Circuit has held that the "bona fide sale" and "adequate and full consideration" elements are "interrelated criteria" and cannot be gauged independently. *Estate of Bigelow v Commissioner* (9th Cir 2007) 503 F3d 955.

Reliance on the bona fide sale exception has provided some success for the taxpayer. See *e.g., Kimbell v U.S.* (5th Cir 2004) 371 F3d 257; *Estate of Anna Mirowski*, TC Memo 2008-74; *Estate of Wayne C. Bongard* (2005) 124 TC 95; *Estate of Charles Porter Schutt,* TC Memo 2005-126; *Estate of Eugene E. Stone III,* TC Memo 2003-309.

Although the entities that are created in the context of planning for vacation properties are typically more modest in size and scope than the partnerships and LLCs that have drawn the attention of the IRS, the questions and issues raised in the current line of decisions remain applicable. They warrant careful consideration and attention when creating an entity for transfer tax planning. For further discussion of family limited partnership issues and precautions to take in entity planning, see §§1.37-1.37E.

© The Regents of the University of California

§4.35 V. REAL PROPERTY TAX ISSUES

Planning for vacation homes invariably involves transfers of interests in real property. It is essential for the attorney to evaluate the impact of the contemplated strategy on property taxes. The basic question is whether the proposed transfer results in a reassessment of the property.

The base year value for determination of property tax is the assessed value of the property on March 1, 1975, or the fair market value when a present interest in the property is transferred. Rev & T C §110.1. Therefore it is critical to determine when a "change of ownership" occurs.

A change of ownership is defined as "a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the… interest." Rev & T C §60. The applicable statutes describe certain transfers that are not regarded as a change of ownership. These include the following:

- *Transfers in which proportional ownership interests remain the same before and after the transfer*. Rev & T C §62(a). This exception covers transfers of vacation property to a general partnership, a limited partnership, or an LLC, provided the transferor's ownership interest in the entity is the same as his or her ownership interest in the property before the transfer. The exception does not apply to creation of a tenancy in common in which an interest is transferred to individuals who were not original owners of the property. That transaction is a change of ownership as to the interest acquired by the new owners.
- *Transfers to revocable trusts*. Rev & T C §62(d).
- *Transfers reserving a term interest or life estate in the transferor*. Rev & T C §62(e). This exception covers creation of a QPRT in which the settlor retains the right to occupy the property during the term of the trust. A change of ownership occurs on expiration of the term of the QPRT or at the death of the settlor prior to expiration of the term when the property is transferred to the named beneficiaries. However if the transfer is to a spouse, child, or grandchild, an exclusion may apply and no change in ownership occurs. Rev & T C §63.1.
- *Interspousal transfers*. Rev & T C §63.
- *Parent-child transfers of a personal residence plus $1 million of other real property*. Rev & T C §63.1. The application of this exclusion to "other real property" allows a protection for transfers of vacation homes.
- *Transfers to grandchildren of a personal residence plus $1 million of other real property*. Rev & T C §63.1(a)(3). This exclusion applies after March 26, 1996, and only if all parents, including stepparents, of the grandchildren are deceased as of the date of transfer. Beginning with fiscal year 2006-2007 and every fiscal year thereafter, a son-in-law or daughter-in-law of the grandparent who is the stepparent to the grandchild does not have to be deceased as of the date of transfer. Rev & T C §63.1(c)(2).
- *Transfer of ownership interests within legal entities*. Rev & T C §64(a). However, this general rule does not apply if the transfer results in (a) any person obtaining, directly or indirectly, a majority ownership of the entity, or (b) in a cumulative transfer of more than 50 percent of the interest in the entity. Rev & T C §64(c)-(d). This exception means that transfer of the vacation home to a partnership or LLC does not constitute a change of ownership, and transfers of fractional interests in the entities can also be made without a reassessment of the underlying property until the transfers result in the original owners relinquishing more than a 50-percent interest. For discussion of transfer of interests in entities and parent-child transfers, see §1.52.
- *Joint tenancy transfers,* provided the original transferor is one of the joint tenants after the transfer. Rev & T C §65(b).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/4 Estate Planning for Vacation Homes/ VI. FORMS/§4.36 A. Form: Sample Management Procedures[1]

VI. FORMS

§4.36 A. Form: Sample Management Procedures

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

4.36-1 Sample management procedures

ATTACHMENT
MANAGEMENT PROCEDURES

A. *Routine Maintenance*.

1. Any Member may engage contractors for, and expend funds of the Company for, or be reimbursed under Section _ _[*e.g., 3*]_ _ for, routine maintenance of _ _[*name of vacation home*]_ _, subject to an aggregate limit of $10,000 per year for all Members. Routine maintenance consists, by way of example and without limitation, of the following:

(a) House cleaning, window washing, lawn mowing, leaf raking, cleaning gutters, removing grapevines and weeds, removing garbage, spring and fall cleanup, shoveling snow off of roof, plowing snow from driveway, putting out and taking in dock and boats, piano tuning, spring and fall opening and closing of plumbing, annual check of septic tank and cleaning, if needed, emergency repairs and routine inspections and maintenance by plumbers, heating and cooling contractors, and other repairmen, minor repairs to dock, boats, and other properties of _ _[*name of LLC*]_ _.

(b) Utility bills, taxes, insurance premiums under existing or renewal policies, boat license fees.

2. Competitive bidding is not required to engage any contractors for routine maintenance.

3. In order to prevent duplication of effort, and for purposes of the Company's books and records, Members must promptly report (a) all engagements of contractors to _ _[*name*]_ _, who will keep a record thereof, and (b) all expenditures of funds for the account of the Company to _ _[*name*]_ _, who will keep a record thereof. The reports may be oral and, in emergency situations, need not precede the engagement or expenditure. _ _[*Name*]_ _ will have primary responsibility for property maintenance relating to _ _[*name of vacation home*]_ _. _ _[*Name*]_ _ will have primary responsibility for paying bills relating to _ _[*specify*]_ _.

B. *Extraordinary Maintenance*.

1. The Members shall consult with one another from time to time regarding extraordinary maintenance requirements of _ _[*name of vacation home*]_ _, which include, by way of example and without limitation, exterior and interior painting, roof repair, replacement of furnace, air conditioning equipment, or kitchen appliances, repair or replacement of stairway to lake or dock other than minor or emergency repairs and other than seasonal putting out and taking in of dock, replacement of windows and doors except glass in broken windows, garage repair or replacement, alteration of driveway, disposal or replacement of boats or boat motors or acquisition of boats or boat motors, alteration or repair of retaining walls or deck other than minor or emergency repairs, power washing and staining deck, landscaping, cutting of trees except (a) pruning and (b) emergency situations, redecorating, remodeling, replacement of furniture or draperies.

2. All extraordinary maintenance items require approval by vote or written consent of Members holding at least a majority of the outstanding interest in the Company as provided in Section _ _. No vote or written consent may be taken without prior notice under Section _ _ and prior consultation of all Members. Each approval must specify the nature and scope of the task, the maximum amount of funds of the Company authorized to be expended, and whether a particular contractor is to be hired or competitive bids are to be solicited. No such approval may require the Company to expend funds in excess of funds available to the

Company under the terms of this agreement.

C. *Other Management Procedures*.

1. The Company may from time to time open one or more bank accounts under Section _ _, engage certified public accountants, attorneys, or insurance consultants, and amend, replace, or add to existing insurance policies. These actions require approval by vote or written consent of Members holding at least a majority of the outstanding interest in the Company as provided in Section _ _. No vote or written consent may be taken without prior notice under Section _ _ and prior consultation of all Members.

2. The Company may not sell, dispose of, assign, transfer, or hypothecate all or any portion of _ _[*name of vacation home*]_ _ without unanimous approval by vote or written consent of all Members, except any withdrawing or surrendering Member or Option Member.

D. *Use of* _ _[*name of vacation home*]_ _.

1. Maximum personal use of _ _[*name of vacation home*]_ _ by the Members and their families and guests, and by individual beneficiaries of any trusts that are Members and their families and guests, at the same or different times, is encouraged, and, except as otherwise provided in this Paragraph _ _[*e.g., D.1*]_ _, this personal use takes precedence over all other use. The Members shall consult from time to time regarding the schedule of personal and rental use and must use their best efforts to establish a schedule of personal use for the next rental season no later than _ _[*specify, e.g., Christmas*]_ _of each year. The schedule will be maintained by _ _[*name*]_ _. Rental uses for the following season may not be scheduled before _ _[*e.g., Christmas*]_ _ of each year without prior consultation of each Member. Any requests for personal use after _ _[*e.g., Christmas*]_ _ of each year will still take precedence over any rental use that has not actually been scheduled with a particular renter. Rental use that has actually been scheduled with a particular renter takes precedence over personal use. For this purpose, "scheduled" means that the Company or any Member has provided an assurance to a particular prospective renter that _ _[*name of vacation home*]_ _ will be available to that person during a particular time period. The assurance need not be in the form of a legally binding rental agreement.

2. Members (and individual beneficiaries of any trusts that are Members) and their families and guests generally will not pay rent, utilities, or cleaning costs to the Company for their personal use of _ _[*name of vacation home*]_ _, all such costs being generally for the account of the Company. However, (a) Members (and individual beneficiaries of any trusts that are Members) and their families and guests must use their best efforts to leave _ _[*name of vacation home*]_ _ in a clean and orderly condition, and (b) Members must separately pay or reimburse the Company for (i) any costs of utilities or cleaning costs attributable to excessive or unusual use and (ii) any costs of utilities, cleaning costs, and opening and closing and other costs attributable to nonseasonal personal use. For this purpose, "nonseasonal" personal use is any personal use between _ _[*e.g., September 15 and May 15*]_ _ other than for purposes of seasonal opening and closing of _ _[*name of vacation home*]_ _.

E. *Renting*.

1. _ _[*Name of vacation home*]_ _ will be rented on a short term basis to vacationers during the rental season to the maximum extent possible when personal use by the Members (and individual beneficiaries of any trusts that are Members) and their families and guests is not desired. The purpose of these rentals is to provide a source of income to the Company to defray all or a portion of the costs of owning and maintaining _ _[*name of vacation home*]_ _, but not otherwise to provide income to the Company or the Members.

2. The Company may from time to time hire a property management company to manage the rental of _ _[*name of vacation home*]_ _ and to provide services in connection with the rental management. The (a) engagement or termination of a property management company, (b) determination or modification of the scope of services to be provided by that company, and (c) determination or modification of the schedule of rental rates for each rental season, each require a vote or written consent of Members holding at least a majority of the outstanding interest in the Company as provided in Section _ _. All Members must be notified under Section _ _ and consulted before any vote or written consent. By such vote or written consent, the Members may delegate to a single Member the authority to approve or reject particular rentals proposed by the property management company and to execute on behalf of the Company any required rental agreements for particular rentals.

3. _ _[*Name*]_ _ will have primary responsibility for rentals of _ _[*name of vacation home*]_ _ and arrangements with any property management company. Subject to approval by the Members of initial engagement, scope of services, and schedule of rental rates as described in Paragraph _ _[*e.g., E.2*]_ _, _ _[*name*]_ _ is authorized to approve or reject particular rentals proposed by the property management company and to execute on behalf of the Company any required rental agreements for particular rentals as described in Paragraph _ _[*e.g., E.2*]_ _.

Comment: This form has been drafted as an attachment to an LLC operating agreement. However, it can be adapted for use as an attachment to a general or limited partnership agreement. It addresses issues related to routine and "extraordinary" maintenance of the property. Each member of the LLC has the ability to engage contractors or expend funds up to an aggregate limit of $10,000 per year for repairs. Provisions covering retention of professional advisors and sale of the property are also included. The form sets forth a mechanism for deciding on a schedule for personal use of the property and discusses procedures for renting the property.

This form was contributed courtesy of Henry M. Grix, Dickinson Wright, PLLC, Bloomfield Hills, Michigan. Minor changes have been made to the form so that it is consistent with California law.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/4 Estate Planning for Vacation Homes/§4.37 B. Form: Sample Vacation Home Trust Provisions[1]

§4.37 B. Form: Sample Vacation Home Trust Provisions

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

4.37-1 Sample vacation home trust provisions

DIVISION I
CREATION OF TRUST

DIVISION II
PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

DIVISION III
DISTRIBUTIONS DURING SETTLOR'S LIFETIME

DIVISION IV
DISTRIBUTION ON DEATH

DIVISION V
VACATION HOME TRUST

A. *Use of Vacation Home.* The trustee will hold the real property that is the primary asset of the _ _[*name of trust*]_ _ Trust for the benefit of the living issue of the settlor, allowing them to use the property for vacations and shorter stays. Before _ _[*e.g., March 1*]_ _ of each year, the trustee will develop, in consultation with each family unit, a schedule for use of the property by all of the family units that wish to use the property over the ensuing year ending _ _[*e.g., February 28*]_ _. To the extent required, first choices in scheduling will be rotated each year among the family units. The trustee will, in the trustee's sole and absolute discretion, make and publish rules regarding the scheduling and use of the premises in order to ensure, insofar as it is reasonably possible, that, over time, each family unit has equal access to the use of the property and treats it in an appropriate and caring fashion.

B. *Funding, Management, and Maintenance.* The _ _[*name of trust*]_ _ Trust is also funded with other assets to provide an initial source of funds for maintaining the property, including taxes, insurance, utilities, repairs, and upkeep, and as a reserve for these items. It is anticipated that these funds will have to be supplemented by charges to family units that use the property as the trustee, in _ _[*his/her/its*]_ _ sole and absolute discretion, determines and that may be required to be paid in advance. To the extent necessary or as is appropriate under the circumstances, the trustee may:

1. Rent the property to persons other than members of family units;

2. Assess all family units, or all family units that use the property, for the upkeep expenses of the real estate.

C. *Sale of Vacation Home*. The real estate may be sold by the trustee and the _ _[*name of trust*]_ _ Trust terminated under the following conditions:

1. A majority of the family units (with each family unit having one vote) vote to sell the real estate;

2. The trustee, in the trustee's sole and absolute discretion, determines that the property is not being used to the extent that continuation of the _ _[*name of trust*]_ _ Trust is justified; or

3. The trustee, in the trustee's sole and absolute direction, determines that it has become economically unsound to continue the _ _[*name of trust*]_ _ Trust.

D. *Right of First Refusal.* If the trustee decides to sell the real estate, any person or persons who are members of a family unit have the right to purchase the property for cash at the appraisal price. Any person wishing to exercise the right to purchase the property must give written notice to each family unit and communicate that desire to the trustee within 30 days of mailing notice. The person receiving notice for each family unit must communicate to other members of the family unit the existence of the notice. If more than one person wishes to buy the property, the trustee will conduct an auction among the various persons and sell the property to the highest bidder. The terms of the sale, other than the fact that it will be for cash, are within the trustee's sole and absolute discretion.

If no family member elects to purchase the property within the 30-day period prescribed for the election, the trustee may offer the property for sale through a licensed real estate broker or directly by the trustee. If the trustee intends to accept an offer from a nonfamily member that is less than the appraisal price_ _[*by more than, e.g., ten percent*]_ _, the trustee must notify the family units. Any member of a family unit will have 10 days from the date notice is mailed to match the offer.

E. *Definition of Family Unit; Representation.* The term "family unit" as used in this document refers only to issue of the settlor. But use of the property by family members may include invited guests and spouses if accompanied by issue of the settlor. The trustee may treat each living child of the settlor who is not incapacitated as the speaker, vote caster, and scheduling contact for his or her family unit. On the earlier of the incapacity or death of a child of the settlor, and thereafter as necessary, the family unit must notify the trustee of its election of a successor family unit representative for purposes of this paragraph.

F. *Optional Termination.* If the majority of the family units elect, the _ _[*name of trust*]_ _ Trust will terminate and the trust assets will be distributed to the then living issue of the settlor, per stirpes. But if a share of the Family Trust is then being held under _ _[*specify division and paragraph*]_ _ for the collective benefit of any such issue, the share or shares will be added to that collective benefit share of the Family Trust and held as a part of it. Any transfer may, but need not, be in connection with the formation of an LLC or other entity to replace in whole or in part the _ _[*name of trust*]_ _ Trust.

If the property is sold, the _ _[*name of trust*]_ _ Trust terminates and the trust assets will be distributed to the then living issue of the Settlor, per stirpes. But if a share of the Family Trust is then being held under _ _[*specify division and paragraph*]_ _ for the collective benefit of any such issue, the share or shares will be added to the collective benefit share of the Family Trust and held as a part of it.

G. *Mandatory Termination.* Unless terminated earlier by action of the trustee or the beneficiaries, the _ _[*name of trust*]_ _ Trust terminates after the death of the last of the settlor's issue living when the settlor's unqualified right to revoke this Trust terminates. At that time, the remaining assets of the Trust's estate will be distributed to the settlor's then living issue per stirpes.

Comment: This form provides sample provisions for use in a trust that is to hold vacation property on the death of the primary owner. It describes a method for rotating use of the property among the family members and outlines a procedure for handling maintenance and other expenses. It specifies the procedure for sale of the property and addresses termination of the trust. For additional trust provisions, see Drafting California Revocable Trusts (4th ed Cal CEB 2003).

This form was contributed courtesy of John A. Scott, John A. Scott, P.C., Traverse City, Michigan. Minor changes have been made to the form so that it is consistent with California law.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/4 Estate Planning for Vacation Homes/§4.38 C. Form: Sample Lake Home Trust[1]

§4.38 C. Form: Sample Lake Home Trust

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

4.38-1 Sample lake home trust

DIVISION I
CREATION OF TRUST

DIVISION II
FAMILY DECLARATIONS

DIVISION III
DEFINITIONS

A. *Lake Home*. The "Lake Home" is my residence on _ _[*address*]_ _, legally described on Schedule "A" together with all the household furniture and furnishings, recreation equipment, docks, boats, and similar personal effects.

B. *Disposition Date*. The "Disposition Date" shall not be less than 25 years after my date of death.

DIVISION IV
PURPOSES AND ADMINISTRATION

A. *Purposes.* It is my purpose in creating this Trust to provide a lake home for my children, their spouses, their descendants, and their guests. I do not desire that any of my children acquire legal title to the Lake Home nor for any child to have the legal ability to force the sale of the Lake Home.

B. *Beneficial Use*. Until the Disposition Date, my children, their spouses, their descendants, and their guests will have the right to use and occupy the Lake Home, rent-free, in such manner as my children agree. If a child is deceased, his or her descendants and his or her spouse will have the right to use the Lake Home generally to the extent it would have been used by the deceased child. Without imposing any strict rules or requirements, each child should generally be able to use the Lake Home approximately 25 percent of the time, which would mean that if a child is deceased, his or her family should be able to use the Lake Home approximately 25 percent of the time.

C. *Trustee's Allocation.* To the extent the children (and a child's respective descendants, if the child is deceased) are unable to agree, the Trustee will allocate the beneficial use of the Lake Home among the beneficiaries in the manner that the Trustee determines, in his or her absolute discretion, to be fair, just, and equitable to all concerned. As a guideline to the Trustee, it is suggested that the Trustee keep and maintain the Lake Home for the benefit of all of the beneficiaries, insofar as practical, bearing in mind possible changes in economic, political, and social conditions, changes in family circumstances, the nearness or distance of those descendants from the Lake Home, their degree of relationship to myself, their interest in the Lake Home, and all of the myriad additional factors that could affect the discretion of the Trustee, whose discretion is absolute.

D. *Admonition.* In view of the very well known fact, one observed by myself frequently, that the equitable sharing of the use and the burden of the Lake Home is a delicate thing, frequently the source of intrafamily bickering and even bitterness, I admonish all persons interested in this Trust to be unselfish and cooperative; to treat the other beneficiaries as they would, in turn, like to be treated by them; and to remember that the purpose of the attempted retention of the Lake Home within the family, for the benefit of the family, is partly to bring the family closer together and not to cause dissention and separation. I therefore earnestly solicit love and consideration of all members of the family for all the other members of the family who have an interest in this Trust. The Trustee is empowered in his or her absolute discretion to take any actions he or she deems appropriate against any beneficiary ignoring this admonition, including temporary or permanent exclusion from

the premises.

E. *Maintenance.* The taxes, insurance, dues, utilities, and other expenses of the Lake Home will be allocated by the Trustee and charged to the beneficiaries in the approximate proportion that the beneficiaries made use of the Lake Home. In so doing, the discretion of the Trustee shall be absolutely conclusive and binding on all persons interested in this trust estate.

F. *Forfeiture.* The rights of any beneficiary to use the Lake Home or to vote for its sale or retention (but not the rights to share in any net proceeds of any possible sale) may be suspended for any period of time or revoked entirely by the Trustee, acting in his or her absolute discretion, if, in his or her opinion:

1. That person fails to take reasonably good care of the premises and, intentionally or through gross carelessness, damages or destroys or permits any of his or her guests to damage or destroy the improvements or the natural habitat of the Lake Home to an extent that the Trustee decides that person is substantially injuring the Lake Home or does not show proper appreciation of the privilege of its use; or

2. That person fails to pay his or her appropriate share of dues, taxes, insurance, maintenance, or other expenses of the Lake Home for 60 days after a final written demand for it, specifying the amount and the fact that failure to pay will cause the invoking of the sanctions of this paragraph; or

3. That person grossly disregards the admonition of Paragraph D above.

G. *Disposition.* Although it is my hope that the Lake Home will be conserved as a whole for the benefit of my lineal descendants, I nevertheless recognize that changed circumstances may make it necessary or advisable to sell the Lake Home. The Trustee is therefore empowered:

1. At any time after the Disposition Date and on concurrence of all of the Trustees then serving (if more than one), together with the affirmative vote of at least 50 percent (in ownership) of all of the beneficiaries of this Trust then of the age of 18 years or older (and not under a legal disability to contract), but not otherwise, the Trustee may give or sell the Lake Home on terms and conditions to be agreed on by the Trustee and the majority of the beneficiaries. There shall be one vote cast for each of the initial beneficiaries, who are my children, or in case of his or her incapacity or death, that one vote is to be cast by the decision of a majority of his or her lineal adult descendants (who are not under a disability) qualifying as beneficiaries by right of representation.

2. If the Lake Home is sold, the net proceeds will be retained in trust. The Trustee shall divide the trust estate into equal shares: one share for each then living child of mine, and one share per stirpes for each deceased child leaving descendants then living. As divided, the share provided for each beneficiary shall constitute a separate, independent, and distinct trust, but all may be administered as one for convenience of accounting and administration.

a. *Income.* The Trustee shall pay to or for the benefit of each child, in quarterly or more frequent installments as convenient, all of the income from the Lake Home held in trust for the child.

b. *Termination.* At the death of a child, the Trustee will at that time distribute the share per stirpes to my child's descendants, subject to the postponement provisions contained in Division V below.

DIVISION V
GENERAL TRUST PROVISIONS

DIVISION VI
TRUSTEE POWERS

Comment: This form provides sample provisions for a revocable trust that is to hold vacation property during the settlor's lifetime and for a specified period after the settlor's death. The trust becomes irrevocable on the death of the settlor. The trust articulates the settlor's goals and intentions with respect to retention of the property. For additional trust provisions, see Drafting California Revocable Trusts (4th ed Cal CEB 2003).

This form was contributed courtesy of Christopher A. Bjornstad, Cornwall, Avery, Bjornstad & Scott, Spencer, IA. Minor changes have been made to the form so that it is consistent with California law.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/4 Estate Planning for Vacation Homes/§4.39 D. Form: Sample Cotenancy Agreement[1]

§4.39 D. Form: Sample Cotenancy Agreement

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

4.39-1 Sample cotenancy agreement

COTENANCY AGREEMENT

PARTIES: **JEFFREY A. DOE and BARBARA D. DOE ("DOE")**

_____

_____

H. JOE ROE and BARBARA E. ROE ("ROE")

_____

_____

RICKY C. COE and KAREN R. COE ("COE")

_____

_____

DATED: _ _[*date*]_ _

RECITALS

A. *Property*. The parties are the owners of a residence property, related improvements, and furnishings located at _ _[*address*]_ _, California; the property and improvements are more particularly described as _ _[*add legal description*]_ _, _ _[*name of county*]_ _ County, California. The furnishings are listed in Exhibit A attached hereto. The residence property, improvements, and furnishings are referred to this document as the "Property."

B. *Ownership Interests*. Ownership interests in the Property are DOE, husband and wife, having an undivided ½ interest; ROE, husband and wife, having an undivided ¼ interest; and COE, husband and wife, having an undivided ¼ interest, all as tenants in common between them.

C. *Purpose of Agreement*. The parties desire to execute an agreement to define their respective rights, liabilities, and responsibilities for the ownership, development, management, and occupancy of the Property and to each other.

AGREEMENT

In consideration of the mutual benefits to be derived from this agreement, and in consideration of mutual promises given in this agreement, the parties agree:

1. *Status*. The parties are joint venturers in the ownership, development, management, and occupancy of the Property. The purpose of the venture is for the investment of capital and not for the active conduct of a business. There will be no more than 3 parties nor more than 6 members to the venture, and each party will own not less than an undivided 25-percent interest in the Property. The relationship between the members may

not be expanded to include any other member, property, or activity, without the written consent of all members. As used in this document, the following terms have the following meanings:

(a) "Member" means each individual who is a participant in this venture.

(b) "Party" means a married couple, each individual who is a member in this venture, or an unmarried individual owning the entire minimum interest described in this paragraph.

2. *Capital*. The capital of the venture will be contributed and owned by the parties in shares that are prorata to their ownership interests described in _ _[*e.g., recitals, Section B*]_ _. The initial capital of each of the parties will be contributed (a) in cash, or (b) by a note issued to the other parties that is due and payable on demand at any time after 15 days from its making.

3. *Increase of Capital*. When additional capital is required or deemed desirable for carrying on the purpose of the venture, the additional capital will be provided by the parties prorata to their respective ownership interests unless they specifically agree otherwise.

4. *Bank*. The members may designate a bank or other financial institution for the transaction of the activities of the venture at any time.

5. *Banking Transactions*. All cash, checks, or money equivalents received by, or on behalf of, the venture must be deposited promptly to the credit of the venture in the bank or financial institution designated by the members for the account of the venture. All withdrawals from the account must be by check drawn and signed by those members as may be designated from time to time.

6. *Meetings*. Meetings may be called by any member on written notice to the other members. Meetings must be held within 30 days from the receipt of the notice.

7. *Books and Records*. The members must designate one of their number to maintain complete and accurate records of all venture business. These records will be open to inspection by any of the members at all reasonable times. At the end of each fiscal year, an account of the venture's affairs must be furnished to each party by the designated member, together with the information required by each party for income tax purposes.

8. *Management.*

Each member will have an equal voice in the management of the venture business.

(a) The members may designate one of their number from time to time as "manager" to attend to the day-to-day affairs of the venture, collect all monies due from the members, and pay all amounts due from the venture. The manager may be designated as the person to maintain the books and records of the venture. Until changed, Jeffrey A. DOE is designated as manager.

(b) A member may give his or her proxy in writing to another member to be voted in his or her place. All decisions relating to the business of the venture will be approved by a vote of members owning ¾ or more of the capital interests of the venture unless otherwise specifically required in this agreement. For purposes of voting the capital interest of each member, the capital interest of each party consisting of two members will be equally divided between them.

(c) The Property and the parties are subject to the rules and regulations of the _ _[*name*]_ _ Association. Every person who appears of record as an owner of a property is a member of the Association. Nevertheless, each property is entitled to only one vote on each matter submitted to a vote of the Association membership. The manager must notify each member of matters to be submitted for a vote of the Association. The manager will cast the vote assigned to the Property as decided by the members owning a majority or more of the capital interests of the venture. If a majority vote of the members cannot be obtained, the manager may cast the vote assigned to the Property as he or she deems appropriate.

9. *Improvement and Maintenance of Property*. Any sale or mortgaging of the Property, or any improvement of the Property requiring the expenditure of $1000 or more may be made only on the unanimous, written consent of all members. Improvements requiring expenditures of less than $1000 may be approved by a vote of members owning a majority of the capital interests of the venture unless otherwise specifically required in

this agreement. An expenditure of $200 or less that furthers the purposes of the venture may be made by any member without the consent of the other members.

(a) Each party must advance, prorata to his or her ownership interest in the Property, monies to a common fund as they are required, to pay for the improvement, maintenance, repair, and operation of the Property, including interest and principal on any debt financing, if any, utility expenses, property taxes, homeowners association dues and assessments, and insurance expenses. Each member of a party is jointly and severally responsible for the payment of the prorata share of all expenses due from the party.

(b) Any anticipated or recurring expenditures payable other than monthly may be estimated by the manager in the form of an annual budget provided to the parties not later than 15 days before the beginning of each calendar year. The manager may elect to collect from the parties the anticipated expenses of the venture in advance and in monthly installments. The payments will be accumulated for future payment of expenses when they become due during the ensuing calendar year.

10. *Lien for Failure to Pay Expenses*. If any party fails or refuses at any time to pay his or her share of the periodic expenses when due under this agreement, and the failure continues for a period of 10 days after receipt of written notice of the failure from any other member, the member or members paying the periodic expense allocable to the defaulting party will have a lien on the defaulting party's interest in the Property in the amount paid. The amount paid will bear interest at the lesser of the maximum rate allowed by law or 10 percent per annum until paid. If there is a bona fide dispute about the existence of a default or of the amount due, and all undisputed amounts are paid, a party will not have the right to place a lien on the disputing party's interest in the Property until the dispute is settled by final arbitration or mutual agreement. The lien provided for in this paragraph will only be effective when it is recorded by the member or members paying the periodic expense with the County Recorder of _ _[*name of county where property is located*]_ _ County, California, signed and verified, and containing at least:

(a) A statement of the unpaid amount of expenses;

(b) A legal description, sufficient for identification, of the defaulting member's interest in the Property that is the subject of the lien;

(c) The name and address of the owner or reputed owner of the interest in the Property that is the subject of the lien; and

(d) The name and address of the member or members paying the periodic expense.

The lien, when so established against the interest in the Property described in the lien, will be superior to any right, title, interest, lien, or claim that may be or has been acquired or attached to the defaulting member's interest in the Property after the time the lien is recorded. The lien will be for the use and benefit of the member or members paying the periodic expense allocable to the defaulting member, and may be enforced and foreclosed in a suit or action brought in any court of competent jurisdiction. But any enforcement or foreclosure action or both may not be commenced unless (i) the amount of the lien(s) recorded under this paragraph exceed $1000, and (ii) the lien(s) must have been recorded for not less than one year.

11. *Restriction on Members*. No member, without the consent of all the other members, may:

(a) Sell, assign, mortgage, rent, lease, grant a security interest in, or pledge his or her interest in the venture, either voluntarily or involuntarily, with or without consideration;

(b) Borrow or lend money on behalf of the venture or purchase any property or security on behalf of the venture;

(c) Assign, pledge, transfer, compromise, or release any claim of the venture except for full payment, or consent to the arbitration of any of its disputes or controversies;

(d) Use the name, credit, or property of the venture for any purpose other than a venture purpose;

(e) Commence or maintain any suit or action for the partition or other division of the Property;

(f) Permit the smoking or consumption of tobacco products within the residence located on the Property;

(g) Permit pets of any kind within the residence located on the Property (except that DOE is permitted to bring their cocker spaniel "Annie" within the residence for the balance of her natural life); or

(h) Do any act detrimental to the venture purpose or which would make it impossible to carry on that purpose.

12. *Sale of an Interest*. Except as provided in Paragraph 22, this paragraph will apply to any sale or other disposition of a party's interest in the Property.

(a) If a party wants to dispose of its interest, it must first offer, in writing, to sell its interest to the other parties at the price determined in accordance with the provisions of Paragraph 16. After the value has been finally determined, the remaining parties will have 30 days in which to elect to purchase the interest. Any party who elects to purchase the interest, must give written notice to the selling party within the 30-day period. The purchase must be closed within 30 days after notice of the election, at which time the purchase price must be paid in cash and in lump sum unless the parties agree otherwise. The parties' right of purchase is prorata as to their respective interests.

(b) If the remaining parties do not elect to purchase, the selling party may sell its interest to any other person acceptable to the remaining parties. Any sale to a nonparty must be for the same or a greater price than the price for which the interest was offered to the remaining parties. If the price is reduced, the interest must again be offered to the remaining parties, and they will have the same 30-day period in which to consider purchasing at the reduced price.

(c) If the nonselling parties fail or refuse to purchase the interest of the selling party and also fail or refuse to approve any other person as purchaser within the time periods described in this paragraph, the venture will be dissolved and terminated following the procedures described in Corporations Code §§16801-16807 for the dissolution and winding up of a partnership in the State of California.

(d) Despite the provisions of this paragraph, any member of a party may sell or transfer all or any part of his or her interest in the Property and the venture to the other member of that party, with or without consideration. If a member of a party transfers all of his or her interest in the Property and the venture to the other member of that party, the transferring member will immediately cease to be a member of the venture and will, for all purposes of this Agreement, be regarded as an unrelated, third person to the acquiring member and the other parties.

13. *Death of a Member*.

(a) When a member dies during the term of this agreement, the surviving member of the party, if any, will automatically succeed to the Property interest of the deceased member.

(b) When the surviving or sole member of a party dies during the term of this agreement, the personal representative of the estate of the deceased member must, within 90 days after appointment, offer the interest of the deceased member for sale to the other parties as described in Paragraph 12. If the surviving parties fail or refuse to purchase the interest as described in Paragraph 12, the interest will pass to not more than one heir of the deceased member designated by him or her, or, in the absence of any designation, to an heir designated by the personal representative of the estate.

14. *Dissolution of Marriage* _ _[*or Domestic Partnership*]_ _. In the event of the dissolution of the marriage _ _[*or the domestic partnership*]_ _ of the members of a party to this agreement, only one of the members of that party may continue in the venture. The name of the member who is continuing in the venture must be furnished to the other parties in a writing signed by both members of the dissolving party. If the members of the dissolving party cannot agree on which member will continue in the venture, and the disagreement continues until the judgment of dissolution becomes final, then within 10 days thereafter the members of the party dissolving their marriage _ _[*or partnership*]_ _ must offer their interest in the Property for sale to the remaining parties as described in Paragraph 12 of this agreement.

15. *Foreclosure*. If any member is the subject of any proceeding to foreclose on his or her interest in the venture or the Property in satisfaction of any obligation of the member, other than as provided in Paragraph

10, and the action is not dismissed within 30 days after filing, the party of which the individual is a member must thereupon offer its interest in the Property for sale to the other parties as described in Paragraph 12.

16. *Purchase Price*. For purposes of this agreement, the purchase price for any interest in the Property offered for sale will be the appraised fair market value of the interest without regard to any applicable discount for a fractional ownership.

(a) To determine the appraised value of the interest in the Property, the selling party, before presenting the offer, must obtain, at his or her own expense, an appraisal of the Property by a certified residential real estate appraiser of its choice. A copy of the appraisal must accompany the offer to sell.

(b) Within 30 days after receipt of the offer, the other parties may accept the offer and elect to purchase the offered interest at the value described in the offer or may reject the offer and, within 30 days after notice of rejection obtain, at their own expense, an appraisal by a certified residential real estate appraiser. On receipt of the appraisal, they must deliver a copy to the selling party. The average of the selling party's original offer and the other parties' appraisal will be the purchase price for the interest in the Property for purposes of this agreement.

17. *Alteration or Amendment*. This Agreement may be altered, amended, or terminated by the unanimous written consent of the members.

18. *Profits*. All venture profits will be distributed annually to the members in proportion to their ownership interests.

19. *Use of Property*. Each party has the exclusive right to use and occupy the Property during the times described in the schedule attached as Exhibit B ("use period"), which assigns the use of the Property among the parties for the period beginning on _ _[*date*]_ _ and ending on _ _[*date*]_ _. Thereafter, the parties must agree on the scheduled uses of the Property and attach the same to this agreement. If the parties cannot agree on the allocation of the use of the Property, the allocation will be determined by lot and will rotate among the parties each year thereafter.

(a) There will be 52 use periods in each calendar year. Each use period consists of seven consecutive days, beginning at 4:00 p.m. on Wednesday of each week and ending at 4:00 p.m. on Wednesday of the following week.

(b) For each 25-percent ownership interest, a party is entitled to one use period out of each 4 consecutive use periods, beginning with the first use period of each calendar year.

(c) For each 25-percent ownership interest, a party is entitled to two use periods in each calendar year each of which contains one of the following holidays: New Year's Eve, President's Day, Easter, Memorial Day, July 4th, Labor Day, Thanksgiving Day, Christmas. No single party is entitled to consecutive use periods that include Christmas Day and New Year's Eve without the consent of the remaining parties.

(d) At the conclusion of each party's occupancy, the party is responsible for fully and thoroughly cleaning the Property before the next party's occupancy.

20. *Golf Privileges*. As owners of the Property, the members are entitled to various use privileges associated with the golf courses owned by the _ _[*name*]_ _ Association. These privileges are subject to change from time to time by the Directors of the Association. The parties agree to cooperate to allocate these privileges equitably among themselves to the end that each member may enjoy any cost or use advantage generally available to all property owners. If the cost or use benefits available in any calendar year are limited to a lesser number per property than all of the members, the members agree to rotate the benefits at least annually with the result that no member enjoys an advantage for more than 2 consecutive years unless all the remaining members agree otherwise. The rotation process will be determined initially by lot, and the order produced will remain in effect until changed by the unanimous agreement of the members.

21. *Responsibility and Use Limitations*. The members acknowledge that by the purchase and maintenance of the Property, valuable benefits will accrue to each of the members, and the parties may make and adjust the rules and regulations for the use of the Property. The rules will cast equal burden and benefit on the members, and under no circumstances will any member use the Property so as to deprive the other members of equal

and similar use. Under no circumstances will the venture or any of the other members be deemed liable or responsible for the torts of any of the members committed on or in connection with the Property or the venture. If any member, or his or her guests, invitees, or licensees, causes any damage to or destruction of the Property, whether through negligence or otherwise, that member will be solely liable to the other parties for the cost of repair and restoration of the Property to its pre-existing condition to the extent the repairs are not covered by insurance maintained by the venture. None of the members is authorized to act as the agent or representative of the other members beyond the specific authority contained in this agreement or the regulations and rules adopted for the venture. The members are not general partners, and their relationship extends only to the co-ownership of the Property.

22. ***Arbitration and Costs*****. If any dispute arises regarding the subject matter of this agreement or its interpretation, the controversy will be settled by arbitration in _ _[*city*]_ _, California, following the procedures set forth in the California Arbitration Act.**

23. ***Transfer by More Than 50 Percent Owner*****. If any party owns more than 50 percent of the Property and the venture after execution of this agreement, then despite the provisions of Paragraph 12 to the contrary, that party will have the right to sell, at any time, that undivided interest in the Property and the venture necessary to reduce his or her ownership interest to 50 percent. The sale must be made solely to one other party. That party must be reasonably acceptable to the other current members of the venture, but the price and terms of sale must be acceptable solely to the selling party, as long as the purchaser agrees to execute and be bound by all the terms and conditions of this agreement as if he or she were an original signatory.**

Executed at _ _[city]_ _, California.

Date: _ _ _ _ _ _ __[*Signature*]__
JEFFREY A. DOE

Date: _ _ _ _ _ _ __[*Signature*]__
BARBARA D. DOE

Date: _ _ _ _ _ _ __[*Signature*]__
H. JOE ROE

Date: _ _ _ _ _ _ __[*Signature*]__
BARBARA E. ROE

Date: _ _ _ _ _ _ __[*Signature*]__
RICKY C. COE

Date: _ _ _ _ _ _ __[*Signature*]__
KAREN R. COE

ACKNOWLEDGMENT:

State of California)
County of _ _[*name of county*]_ _ **)**

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

Comment: This form is an example of a cotenancy agreement that could be executed by the co-owners of the vacation property. It addresses such issues as contribution of capital for improvements and maintenance and sale of a party's interest in the property. It provides an initial schedule for use of the property. If the parties cannot reach agreement on schedules for succeeding years, use is determined by a blind drawing conducted by lot. Arbitration is required for resolution of any disputes among the owners.

This form was contributed courtesy of D. Charles Mauritz, Davis Wright Tremaine, LLP, Portland, Oregon. Minor changes have been made to the form so that it is consistent with California law.

© The Regents of the University of California

5

Estate and Inheritance Tax Planning for California Residents With Out-of-State Property

Robin L. Klomparens
Betty J. Little

I. OVERVIEW OF PHASE-OUT OF FEDERAL ESTATE TAX §5.1

II. EFFECTS OF STATUTORY SCHEME

A. Phase-Out of State Death Tax Credit §5.2

B. State Tax Schemes §5.3

C. Effect on Estate Tax Rates §5.4

D. California §5.5

E. Decoupled States §5.6

1. Decoupled States in 2008 §5.7

2. Decoupled States After Phase-Out of State Tax Credit §5.8

3. Hypothetical Decoupled State §5.9

III. UNIFIED CREDIT AND STATE EXEMPTION AMOUNTS §5.10

IV. PLANNING ISSUES

A. California Domiciliary §5.11

B. Planning Options

1. Sale of Property §5.12

2. Gifting Before Death §5.13

3. Formation of Entity §5.14

C. Planning Issues for Married Persons §5.15

1. Bypass and Marital Trusts Issues §5.16

2. Reduction of Marital Deduction by "Phantom"Tax §5.16A

3. Planning Options §5.17

a. Qualify Additional Property for Marital Deduction §5.18

b. State QTIP Trust §5.19

c. Clayton Trust §5.20

d. Wait and See §5.21

e. Disclaimer §5.22

f. Pay Tax §5.23

V. ADDITIONAL RAMIFICATIONS OF STATE TAX CREDIT PHASE-OUT §5.24

VI. TAX APPORTIONMENT §5.25

VII. APPENDIX: STATUS OF STATES REGARDING DECOUPLING §5.26

© The Regents of the University of California

§5.1 I. OVERVIEW OF PHASE-OUT OF FEDERAL ESTATE TAX

In the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), Congress mandated the phase-out of the federal estate tax by the year 2010 (subject to the sunset provision), which has seriously affected estate planning throughout the country. The state death tax credit's reduction, and ultimate elimination, has created situations in which combined state and federal estate taxes will often rise between 2003 and 2009. This result is contrary to the general public belief that overall estate taxes have been decreased.

Some states impose a state death tax that is not offset by the elimination of the federal credit, so they could maintain the amount of taxes they received from estates. See §5.6. Conversely, some states lost their entire estate tax revenue in 2005. See §5.3. The increase in the federal credit applicable exclusion amounts for estate tax has also complicated planning for both married and single persons from a state death tax perspective (if federal and state exclusion amounts differ, see §5.10), and therefore overall estate tax planning has become more complex. Due to the various planning issues, California practitioners need to be aware of any client's out-of-state property.

© The Regents of the University of California

II. EFFECTS OF STATUTORY SCHEME

§5.2 A. Phase-Out of State Death Tax Credit

Under IRC §2011, the credit for state death taxes was reduced in the years 2002, 2003, and 2004 by 25 percent each year. Beginning in 2005, the state death tax credit has been eliminated; instead, state death taxes actually paid are deductible under IRC §2058. EGTRRA-2001's phase-out of the state credit caused the tax rate reduction in the first 3 years to come largely, or entirely, from the state tax, rather than the federal tax.

The impact of the elimination of the state death tax credit not only depends on the type of death tax imposed by a particular state but on the value of the total estate, the state's applicable exclusion amount, whether the estate can benefit from the IRC §2058 deduction, and whether the decedent owned property in more than one state. For discussion of the various state statutory schemes, see §§5.3-5.9.

© The Regents of the University of California

§5.3 B. State Tax Schemes

Before EGTRRA-2001, most states had a "pick-up" tax, also called a "sponge tax," that allowed a state to collect the maximum federal credit on taxable estates. This system was easy to administer yet allowed states to collect revenue on estates that were taxed for federal estate tax purposes. Although these states received revenue on taxable estates, estate taxes at the state level had little impact on planning. If all estate assets are located in a pick-up state, the pick-up tax equals the amount of the IRC §2011 state death tax credit actually allowed to the estate. When the credit dropped to zero in 2005, the pick-up tax dropped to zero. California has this statutory scheme, and therefore no revenue was received by the state in 2005 and thereafter. A change in the California law is unlikely because California is constitutionally prohibited from changing its estate tax scheme by legislative action. Cal Const art II, §10(c).

Some states impose an independent state tax ("non-sponge" tax) in an amount that is not necessarily the same amount as the IRC §2011 credit. Until the enactment of EGTRRA-2001, most independent state estate taxes were computed in the same manner as a pick-up tax, but the actual statutes were worded in a way that did not automatically incorporate any changes in federal law. In states that already had an independent estate tax, the tax continues until the legislature takes affirmative action to change it. Some of these states have taken action to conform to EGTRRA-2001—thereby phasing out the state estate tax—but other states have not.

Other states impose inheritance taxes. Inheritance taxes are imposed separately on each transferee. Typically, an inheritance tax has rates and exemption amounts that vary depending on the relationship between the decedent and the transferee, with lower rates and higher exemption amounts applying to spouses, children, and other closer relatives. Inheritance tax states have pick-up taxes that pick up any amount of the allowable IRC §2011 credit that may remain after imposition of the inheritance tax.

States that now have estate taxes that were not phased out by the elimination of the IRC §2011 credit are said to have "decoupled." Decoupling means severing the relationship between the federal and state tax. The great majority of decoupled estate taxes are decoupled not only with respect to the IRC §2011 phase-out, but also with respect to the IRC §2010 applicable exclusion amount that equals the largest value of the estate that will not result in an imposition of tax. Most decoupled states impose a state death tax using a pre-EGTRRA IRC §2011 rate schedule. States have taken this approach to increase revenue, but for individuals this causes an increase in taxes.

A decoupled state may impose taxes (on a limited prorata basis) if the federal and decoupled state exclusions differ. Consequently, even residents of sponge tax states must be careful if their estate includes property located in a decoupled state. Under most state death tax schemes, intangible personal property of a United States domiciliary is taxed by the state of the decedent's domicile. However, real property and tangible personal property are taxed by the state in which the property is located.

EXAMPLE: If a decedent resided in a sponge state but held tangible property in Rhode Island, a decoupled state, Rhode Island will levy a prorata estate tax if taxable distributions exceeded $675,000 (the applicable state estate tax exclusion amount) even if those distributions did not exceed the federal exclusion amount. RI Gen Laws §44-22-1.1.

A minority of states that have not decoupled have a "nullification" clause that makes the pick-up tax void if the federal credit for state death taxes is repealed, or if the federal estate tax is repealed.

The status of the 50 states and the District of Columbia is summarized in §5.26.

© The Regents of the University of California

§5.4 C. Effect on Estate Tax Rates

The reduction in the total marginal rate in years after 2001 depends on whether states acquiesce to the phase-out of the state death tax. For pick-up states, the effective federal rate declined one percent to 38 percent in 2002, but rose to 41 percent in 2003 and 44 percent in 2004. From 2005 to 2009, the federal rate becomes the total rate, and varies from 45 percent to 47 percent.

For decoupled states, the top marginal federal estate tax rate causes substantially higher rates in each year from 2003 to 2009. See §§5.7-5.9. Most states are in political and economic turmoil over this issue. Some, like California, are constitutionally prohibited from changing their death tax scheme by legislative action. See Cal Const art II, §10(c).

The top state death tax credit rate under IRC §2011 (pre-EGTRRA 2001) is 16 percent, and unless revised will be the top marginal state death tax rate. Until 2004, this rate applied to taxable estates in excess of $10,100,000 (*i.e.,* adjusted taxable estates of $10,040,000).

© The Regents of the University of California

§5.5 D. California

Although California does not have a nullification clause, the statute is worded in a way that the tax cannot exceed the federal credit allowed—it is a pure pick-up or sponge tax. For example, Rev & T C §13302 provides that an estate tax is imposed equal to the "maximum allowable amount of the credit for state death taxes." These statutes produced a declining pick-up tax for deaths in 2004, and no tax in 2005 and thereafter. It is estimated that the annual loss of revenues in California alone is $1.55 billion.

In California, even though the pick-up tax disappears automatically, the state Constitution directly or indirectly prohibits enactment of a replacement. Cal Const art II, §10(c). Therefore, California will receive no revenue on the death of its residents, even if that resident has a taxable estate for federal estate tax purposes. Because of other states' statutory schemes, however, a decedent domiciled in California may be liable for state death taxes on property located in a decoupled state.

NOTE: Until August 2004, New York imposed a state death tax based on the *entire* estate, regardless of where the estate's property was located, and then allowed a credit equal to the lesser of (i) the amount of the death tax paid to the other state or states that is allowable as the federal credit for state death taxes or (ii) an amount determined by multiplying the maximum amount of the federal credit for state death taxes by a fraction, the numerator of which is the decedent's federal gross estate reduced by his or her New York gross estate and the denominator of which is his or her federal gross estate. See former NY Tax Law §952. Under this formula, the New York credit for a California resident dying after 2004 would be zero because California will have no death tax. Former §952 was repealed and NY Tax Law §§952 and 960 now provide that the New York estate tax on New York real and tangible personal property owned by a non-New York decedent will equal the same proportion of the pre-EGTRRA federal credit for state death taxes that the New York property bears to the federal gross estate.

If a California decedent owned property that was located in states other than California at the time of his or her death, the California estate tax is a proportionate amount of the allowable federal credit for state death taxes. Apportionment of the tax is computed by dividing the value of the "property located in California" by the gross value of the federal estate "as finally determined for federal estate tax purposes." Rev & T C §13304.

The definition of "property located in California" changes depending on the following (Rev & T C §13304; 2 Cal Code Regs §1138.20):

California Resident Decedents

Real property. Land, buildings, and long-term leaseholds, located in California.

Tangible personal property. Cars, boats, bullion, collectibles, furniture, furnishings, jewelry, and artwork having an actual situs in California.

All intangible personal property. No matter where the promissory notes, bonds, stock certificates, or other evidence of ownership may be physically located or where the banks or other debtors of the decedent may be located or domiciled.

United States Resident Decedents, but Nonresidents of California

Real property. Land, buildings, and long-term leaseholds located in California.

Tangible personal property. Cars, boats, bullion, collectibles, furniture, furnishings, jewelry, and artwork having an actual situs in California.

Intangible personal property. Only that located in California, including all stock of corporations organized under the laws of California or that have California as their principal place of business or that do a major part of their business in California.

Real estate in other states and tangible personal property with an actual situs in another state will give rise to an allocation of the estate tax credit with the other state(s) under California's system of sharing the pick-up tax.

Because this is a system for dividing the federal state death tax credit, there is no concept of credit for taxes paid to another state like there is in the income tax laws. Because California may treat property located out of state in a manner that is different from the requirements of other states, it is not uncommon for the total of all the state death taxes to exceed the amount of the federal credit, even in a state where the exclusion amount conforms to the federal exclusion amount.

© The Regents of the University of California

§5.6 E. Decoupled States

The District of Columbia and several states have responded to EGTRRA by decoupling their estate taxes from the federal scheme. Many of these states have frozen their unified credit at amounts lower than the current federal unified credit. There has been a dramatic increase in the number of states imposing a state death tax not offset by the federal deduction, so that these states could maintain the amount of taxes they received from estates. In decoupled states, taxes are typically imposed at the same rate as the phased-out credit. See §5.3. For clients, decoupling effectively increases their combined state and federal estate taxes. See §§5.7-5.8.

© The Regents of the University of California

§5.7 1. Decoupled States in 2008

A decedent who dies in a decoupled state in 2008, when the federal estate tax credit has been eliminated and the maximum federal estate tax rate is 45 percent, assuming a maximum state tax of 16 percent, faces a maximum combined state and federal estate tax rate of 53.8 percent in 2008. See chart in §5.8. This is 8.8 percent higher than the 45 percent that will be imposed in a state that has a sponge tax.

© The Regents of the University of California

§5.8 2. Decoupled States After Phase-Out of State Tax Credit

The chart below illustrates that prior to repeal in 2010 in a decoupled state, depending on the year of death, there is either an increase in the marginal rate, or a modest decrease if the top state rate is again presumed to be 16 percent.

Year	Effective Federal Rate	State Rate	Effective Combined Rate After Credit or Deduction
2001 (pre-EGTRRA)	39%	16%	55.00%
2002	38%	16%	54.00%
2003	41%	16%	57.00%
2004	44%	16%	60.00%
2005	47%	16%	55.48%
2006	46%	16%	54.64%
2007	45%	16%	53.80%
2008	45%	16%	53.80%
2009	45%	16%	53.80%
2010	0	16%	16.00%

© The Regents of the University of California

§5.9 3. Hypothetical Decoupled State

To highlight the potential additional tax burden in a decoupled state compared to a pick-up state like California, assume that a decoupled state had an estate tax tied to the former IRC §2011 credit amount. Assuming a state estate tax exclusion amount of $1 million and adjusting for the state death tax credit, the additional tax burden is illustrated by the chart below.

2009				
Taxable Estate	**State Tax**	**Net Increase**	**Marginal State Rate**	**Effective Combined Rate**
1.1 million	$27,600	$27,600	6.4	6.4
2.1 million	$106,800	$106,800	8.0	8.0
3.1 million	$190,800	$190,800	9.6	9.6
4.1 million	$290,800	$159,940	11.2	51.16
5.1 million	$402,800	$221,540	12.0	51.6
6.1 million	$522,800	$287,540	12.8	52.04
7.1 million	$650,800	$357,940	13.6	52.48
8.1 million	$786,800	$432,740	14.4	52.92
9.1 million	$930,800	$511,940	15.2	53.36
10.1 million	$1,082,800	$595,540	16.0	53.8

- *Net increase after factoring in IRC §2058 federal deduction for state estate tax:* In 2009, when the applicable exclusion amount is $3.5 million and the maximum federal tax rate is 45 percent (IRC §§2001(c)(2)(B), 2010(c)), the state estate tax deduction on a taxable estate of $4.1 million results in federal estate tax savings of $130,860 (.45 x $290,800), and the net increase in the combined state and federal estate tax is $159,940.

- *Effective combined rate after deduction:* The state tax rate on $4.1 million is 11.2 percent. Thus, the estate received a federal deduction equivalent to 5.04 percent (11.2 percent of 45 percent), making the effective federal rate 39.96 percent (45-5.04 = 39.96) and an effective combined state and federal estate tax of 51.16 percent (39.96 + 11.2 = 51.16).

© The Regents of the University of California

§5.10 III. UNIFIED CREDIT AND STATE EXEMPTION AMOUNTS

The interplay between the unified credit and state death taxes means that the amount of state death tax may be affected by both EGTRRA's increases in the applicable exclusion amount as well as its reductions in the state credit. Higher tax rates are not the only problem in decoupled states. If a state recognizes the increases in the unified credit, there will be no state death tax on a net estate equal to the applicable exclusion amount, even if the state does not recognize the changes to IRC §2011. If the state does not recognize the increases in the unified credit, there may be a state death tax on an estate even if it does not exceed the applicable exclusion amount.

For example, Maine, Massachusetts, and Minnesota have linked their exclusion amounts to the pre-EGTRRA applicable exclusion amounts ($700,000 for estates of persons dying in 2002-2003; $850,000 for estates of persons dying in 2003; $950,000 for estates of persons dying in 2004; $1 million for estates of persons dying after 2005). Me Rev Stat Ann tit 36 §§4061-4062; Mass Gen Laws ch 65C §§2A(a), 3; Minn Stat §§291.03, 289A.10(1). New Jersey and Rhode Island have set their exclusions at $675,000; the District of Columbia (for persons dying on or after January 1, 2003), New York, and Nebraska (for decedent's dying before January 1, 2007) have frozen their limits at $1 million. NJ Stat Ann §54:38-1; RI Gen Laws §44-22-1.1; Wis Stat §72.01; DC Code Ann §47-3701; NY Tax Law §951; Neb Rev Stat §77-2101. Because states like these have not linked the value of assets exempt from state estate taxes to the increased exclusion amounts enacted by EGTRRA, estates in these jurisdictions may owe state estate taxes even if they are exempt from federal estate taxes.

EXAMPLE: A New Jersey taxable estate worth $3.5 million will be exempt from federal estate taxes in 2009, but it will still be subject to state estate taxes because the maximum available state exclusion, determined as if the decedent died on December 31, 2001 (the relevant date under the applicable New Jersey statute), is only $675,000. See §5.16A.

A state that only has the right to tax a portion of the decedent's property can calculate its tax based on the value of the decedent's entire estate—at least if the required calculations also reduce the tax in a manner that sufficiently takes into account the fact that other portions of the estate are located outside the state. So, for example, a decedent domiciled in California who has a gross estate of $5 million that includes property in Massachusetts, a decoupled state, will be subject to a Massachusetts estate tax equal to the Massachusetts tax rate times the proportionate value of the Massachusetts property divided by the value of the decedent's gross estate.

NOTE: It is important for planners to look at each particular state where their client owns property to see exactly how taxation is calculated and review the tax clauses carefully.

© The Regents of the University of California

IV. PLANNING ISSUES

§5.11 A. California Domiciliary

Property owned by a California domiciliary that is located in a decoupled state would be subject to that state's independent estate tax. If the state uses pre-EGTRRA applicable exclusion amounts (as many do; see §5.10), a California domiciliary will not have a significant estate tax problem as long as the total net value of the estate is under $700,000 and stays under $1 million as the pre-EGTRRA exclusion amounts rise to that level in 2005. If death occurred in 2005 or later (ignoring the sunset of EGTRRA), any death tax payable to the decoupled state will be deductible on the decedent's federal estate tax return under IRC §2058. In most cases, this deduction will be worthless, however, because the estate will not owe federal estate taxes, due to the higher federal estate tax exclusion amounts.

If the decoupled state has not conformed to any provisions of EGTRRA, it may still allow the IRC §2057 qualified family-owned business interest deduction. If so, it may be possible to shield a total of $1.3 million from state estate tax even if the state uses a lower applicable exclusion amount and the business property is located in California. (On the other hand, certain favorable EGTRRA amendments to IRC §2031(c), concerning qualified conservation easements, may not be applicable.)

If it is necessary to pay estate taxes in the decoupled state, the taxes will be higher than if all the client's assets were located in California. The amount of additional tax will depend on:

- The value of the total estate;
- The value of the property in the decoupled state;
- The state's applicable exclusion amount; and
- Whether the estate can benefit from the IRC §2058 deduction.

Clients who consider the potential tax consequences to be serious enough have several options. They can sell the property (see §5.12), make an inter vivos gift of the property (see §5.13), or convert the property into intangible personal property that will be California property for estate tax purposes by conveying the property to a business entity (see §5.14). Married clients have additional planning options. See §§5.15-5.22.

© The Regents of the University of California

B. Planning Options

§5.12 1. Sale of Property

The client could consider selling property held in a state with a decoupled statute, particularly if the decedent is a resident in a sponge tax state. Any death tax advantages realized by a disposition of the property may, however, be offset by the capital gains on the sale of appreciated property, although an IRC §1031 exchange for property in a sponge tax state can be explored. The optimum tax consequences can only be compared by computing the various alternatives under assumed conditions (*e.g.,* amount of expected appreciation; present and future tax rates) and comparing the results.

© The Regents of the University of California

§5.13 2. Gifting Before Death

Another option in states that impose no gift tax due to decoupling, but impose a state death tax in excess of the state death tax credit or deduction, is to make a gift before death. This avoids a state death tax on the gifted property and allows a significant tax savings. This savings increased as the IRC §2011 credit decreased in the years 2002 through 2004. In 2004, the savings equaled 12 percent of the gift. In 2005 and thereafter, when the state death tax became deductible, the maximum saving is in excess of 8 percent.

One must be aware of the IRC §2053 3-year rule requiring inclusion of any gift taxes paid 3 years before death. One must also calculate the cost of the gift (use of decedent's federal exclusion amount and loss of step-up in basis). Decoupled state domiciliaries may wish to make cash gifts to avoid the step-up issue.

NOTE: The gift option may be counterproductive if the donee will soon sell the property and incur a capital gain tax (although a taxpayer may want to incur estate tax to obtain a step-up in basis). The gift strategy works best in the case of a vacation property or other asset that will be retained by the donee.

© The Regents of the University of California

§5.14 3. Formation of Entity

Finally, any out-of-state real property in a decoupled jurisdiction can be contributed to a limited partnership or a limited liability company (LLC). The entity is intangible property and will be taxed in the state of the decedent's domicile, not in the state where the property owned by the entity is located.

Whether this strategy makes sense depends on comparing the costs of establishing and operating the entity with the potential estate tax liability. A California LLC must pay an annual franchise tax of $800, plus a statutory fee for any year in which the LLC's total income from all sources derived from or attributable to this state, *i.e.,* prorata gross revenues, is $250,000 or more. Rev & T C §§17941-17943, 19394, 23153(d)(1).

NOTE: Revenue & Taxation Code §19394 was added to permit the recomputation of the Rev & T C §17942 statutory fee in response to *Northwest Energetic Servs. LLC v Franchise Tax Board* (2008) 159 CA4th 841, 71 CR3d 642 and *Ventas Finance I, LLC v Franchise Tax Board* (2008) 165 CA4th 1207, 81 CR3d 823, in which the gross receipts-based LLC fee in former Rev & T C §17942 was held to be unconstitutional because it was based on an LLC's worldwide gross revenues, and had no apportionment method.

California limited partnerships are subject to an annual franchise tax of $800. Rev & T C §§17935-17936, 23153. However, limited partnerships and LLCs offer significant estate planning opportunities, including the ability to make discounted gifts of interests in the entity. See chap 1. See also Advising California Partnerships §§5.9-5.11 (3d ed Cal CEB 1999); Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007).

© The Regents of the University of California

§5.15 C. Planning Issues for Married Persons

Many issues associated with planning for married couples arise at the planning stage or on the first death. The impact of EGTRRA has to be analyzed when drafting documents for clients owning out-of-state property. On the first death, many options may exist and decision-making can be difficult because of a variety of unknowns.

© The Regents of the University of California

§5.16 1. Bypass and Marital Trust Issues

The difference between federal and state exclusions does more than complicate estate administration; it also creates potential problems for bypass and marital trusts. When the first of a married couple dies, a formula division of the estate often produces a bypass trust (also called credit trust or residual trust), equal to the applicable exclusion amount. Until EGTRRA, such a division produced no state tax, because of former IRC §2011(f). In a state that does not recognize EGTRRA's increases in the unified credit for the state exclusion amount, that formula division will now generate a state death tax.

EXAMPLE: Assume the federal exclusion amount is $3.5 million, but the state only provides an exclusion amount of $800,000. The formula creates a bypass trust of approximately $3.5 million, which exceeds the state exclusion amount by $2.7 million, thereby triggering a state tax on $2.7 million at the first death.

The practitioner must consider whether it is preferable to pay the state tax on the first death or to shrink the size of the bypass trust to $800,000 in order to avoid the state tax. Factors that must be weighed to make such a decision include:

- Life expectancy of the survivor;
- Potential federal exclusion amount for the year of the survivor's death;
- Estimated size of the survivor's estate;
- Status of repeal of EGTRRA; and
- Liquidity and anticipated appreciation.

Unfortunately, the planner does not have a crystal ball, and much of this information requires guesswork and conjecture. The available information may or may not be much better 9 or 15 months after the first death, but additional time at least preserves that possibility. Because of these issues, care has to be taken in planning and flexible estate plans have to be considered.

© The Regents of the University of California

§5.16A 2. Reduction of Marital Deduction by "Phantom" Tax

Another issue presented in at least one decoupled state is the risk of having the state taxable estate increased by a "phantom" federal estate tax that was never paid. In *Estate of Stevenson v Director, Div. of Taxation* (2008) 23 NJ Tax 583, the New Jersey Tax Court ruled that a tax clause that required payment of all estate taxes from the marital share of the residue of the estate resulted in a larger state estate tax by reducing the marital deduction equal to a hypothetical federal estate tax that would have been due if the decedent had died on December 31, 2001. In *Stevenson*, the decedent's will had a residuary marital formula. Accordingly, the estate's distributions were divided into two separate portions: (1) a credit shelter portion equal to the maximum amount that could pass free of both state and federal estate taxes on the date of the decedent's death (in this case $675,000 because the New Jersey statute refers to the IRC as "in effect on December 1, 2001" (NJ Stat Ann §54:38-1)), payable to the decedent's issue; and (2) a marital portion consisting of the residue of the estate. The will specified that all death and inheritance taxes were to be paid out of the residue (the marital portion). (The bulk of the estate passed outside the will under a transfer-on-death agreement.)

New Jersey imposes an estate tax on "the transfer of the estate of every resident decedent dying after December 31, 2001 which would have been subject to an estate tax payable to the United States under the provisions of the federal Internal Revenue Code of 1986 … in effect on December 31, 2001." NJ Stat Ann 54:38-1. The amount of the tax is "the maximum credit [for state taxes] that would have been allowable under the provisions of that federal Internal Revenue Code in effect on [December 31, 2001] against the federal estate tax that would have been payable under the provisions of that federal Internal Revenue Code in effect on [December 31, 2001]." NJ Stat Ann 54:38-1. The New Jersey Tax Court reasoned that the language of the statute required the estate to first calculate the hypothetical federal estate tax in effect on December 31, 2001, and identify the maximum state death tax credit that would have been available if the decedent had died on that date.

Treasury Regulation §20.2056(b)-4(c)(4) provides that for purposes of calculating the federal estate tax marital deduction, if the payment of federal and state death taxes is to come from the residuary (marital) portion of a gross estate, the marital deduction is reduced by the amount of death taxes so payable. Accordingly, federal estate taxes that would have been due if the decedent had died in 2001 but that were not actually assessed or paid because the decedent died in December 2005, when the unified credit was $1.5 million (the "phantom tax"), were deducted from the amount available for the marital deduction in calculating the 2001 hypothetical federal estate tax, further reducing the residuary estate eligible for the marital deduction and thus increasing the New Jersey estate tax. (The marital deduction and the amount of federal estate tax are interrelated and neither can be determined without knowing the other. The problem can be solved by an algebraic formula, and the court assumed that the plaintiff used such a formula to take the federal and the state estate taxes into account. 23 NJ Tax at 589.) The hypothetical marital deduction was reduced from approximately $406,000 to $36,000; as a result the New Jersey estate tax was increased on the basis of the hypothetical state tax credit from approximately $55,000 to $77,000. 23 NJ Tax at 588.

Although *Stevenson* has been criticized on policy grounds as overriding the purpose of the marital deduction statutes, its conclusion nonetheless follows from a literal reading of the New Jersey statute. Accordingly, drafters should think twice before using tax clauses that require estate and inheritance taxes to be paid from the residue without specifying that taxes may not be paid from property in the residue that qualifies for the marital deduction. If all property in the residue qualifies for a federal estate tax deduction (*e.g.*, a marital or charitable residuary clause), a nonresiduary tax apportionment clause that requires taxes to be paid from the property that generates the tax should be considered, particularly in a decoupled state. This case further illustrates the need to carefully analyze tax clauses under federal and applicable state law. Practitioners should be aware of this potential problem and revise tax clauses to avoid the imaginary tax of the *Stevenson* decision.

Stevenson presents a unique factual situation. In more typical circumstances, probate assets will be adequate to fund the credit shelter trust in an amount necessary to pay the federal estate tax on the exemption amount. The reasoning in the decision, however, could be applied in any decoupled state (depending on the language of the statute and the formula residuary clause), so practitioners should be aware of the potential for a *Stevenson*-type situation.

© The Regents of the University of California

§5.17 3. Planning Options

The state death tax could be avoided by limiting the bypass trust to the size of the applicable exclusion amount under pre-EGTRRA law that applies in a particular state. For instance, if the provisions governing the creation of a testamentary bypass trust include minimum taxation language, a trust established in 2008 by a New Jersey decedent could be funded with only $675,000 without incurring any estate tax. NJ Stat Ann §54:38-1. The personal representative might fund a bypass trust with less money than the decedent planned to avoid federal and state estate taxes. By the same token, funding a bypass trust to the federal applicable exclusion limit may inadvertently trigger state taxes that were not anticipated in the original estate plan. If the New Jersey trust included provisions that allowed the full use of the available federal exclusion amount, the estate would have to pay New Jersey estate taxes. Although paying the state death tax may be an acceptable price for keeping the additional trust property out of the surviving spouse's gross estate, that will not be the case if the surviving spouse lives until repeal of the federal estate tax or at death resides in a state that has a sponge tax while holding out-of-state property.

Practitioners may address many of the EGTRRA-created issues by drafting flexible provisions and using techniques such as qualified disclaimers. For example, testamentary instruments may combine minimum total tax provisions with disclaimer powers that allow a surviving spouse to disclaim a portion of his or her bequest to a bypass trust in order to avoid under-funding the bypass trust. See §5.22. Clayton QTIP trusts serve this purpose admirably by deferring funding decisions until a testator's death, so these trusts may become more popular in the decoupled states. See §5.20.

The decoupling issue may make it more likely that drafting options other than the standard marital deduction formula clause are explored. For example, a bypass trust that is eligible for a QTIP election (at least for the fraction of the trust that is attributable to the difference between the state exclusion amount and the federal exclusion amount) may be created. The document would allow the estate's executor to elect the funding amount for a QTIP trust. If, after the first death, it appears prudent to make a QTIP election for more property than would be necessary in order to reduce the federal tax to zero, the executor or trustee can do so. See §§5.17-5.18.

Whatever solutions estate planners choose, they must recognize that EGTRRA has created a situation in which domicile considerations and careful vigilance will be the norm for some time to come.

© The Regents of the University of California

§5.18 a. Qualify Additional Property for Marital Deduction

State death tax at the death of the first spouse to die may be avoided by qualifying "additional" property for the marital deduction, either through the use of an outright marital deduction or by funding a QTIP trust. A minimum total tax formula utilizing the lesser of the state death exclusion amount or the federal exclusion amount may divert a portion of the first spouse's federal exclusion to a QTIP trust at the expense of the bypass trust.

The problem with this approach is that when the surviving spouse dies, the property may be subject to both federal and state death tax depending on the exclusion amount in the year of the surviving spouse's death and the domicile of the surviving spouse on death. If the surviving spouse is willing to change his or her residence to a state that does not impose a tax, then state tax can be avoided. If however, the spouse is in a decoupled jurisdiction, state death tax may be imposed even if no federal estate tax is imposed.

© The Regents of the University of California

§5.19 b. State QTIP Trust

Some states, such as Indiana, Massachusetts, Ohio, Oregon, Pennsylvania, Rhode Island, Tennessee, and Washington, have tried to provide a solution to this dilemma by allowing state QTIP trusts. In these states, an executor could fund the following trusts: a bypass trust with the partial federal and the full state exemption; a second bypass trust with the difference between the federal and state exclusion, utilizing a state QTIP election, and a traditional QTIP trust with the remaining assets in the estate (federal and state amount over the federal annual exclusion). This solution eliminates the imposition of any state or federal estate tax on the first spouse's death, but also effectively increases the surviving spouse's estate because that spouse must receive the income from the state QTIP trust. Also a QTIP trust cannot make distributions to a nonspouse beneficiary during the spouse's lifetime.

EXAMPLE: Assume that the decedent's estate is $4.5 million, the federal exclusion amount is $3.5 million, and the state exclusion amount is $1 million. The bypass trust would hold $1 million, the QTIP bypass trust would hold $2.5 million ($3.5 million less $1 million), and the QTIP trust would hold $1 million. In the year of the surviving spouse's death, only the QTIP trust is subject to estate tax for federal purposes, while both the QTIP bypass trust and the QTIP trust are subject to estate tax for state purposes. Note that *Estate of Stevenson v Director, Div. of Taxation* (2008) 23 NJ Tax 583 should likewise be addressed in a decoupled state when an estate plan includes a QTIP election. See §5.16A.

© The Regents of the University of California

§5.20 c. Clayton Trust

In some situations, the drafter may consider using a "Clayton QTIP" trust. This type of trust is named after the case of *Estate of Clayton v Commissioner* (5th Cir 1992) 976 F2d 1486, reported in 14 CEB Est Plan R 80 (Dec. 1992). A Clayton QTIP trust eliminates the surviving spouse's income interest for the nonelected portion of the trust. The spouse receives all income only for the portion of the bypass trust for which the executor makes the QTIP election. In essence, the executor makes the QTIP election for a fraction of the bypass trust that equals the difference between the federal and the state exclusion amounts. See Reg §20.2056(b)-7(d)(3), (b)-7(h), Example 6. Although the regulation states that the executor making this election does not hold a power of appointment, it does not address the situation of a surviving spouse executor/trustee who decides whether or not he or she will receive income. See Reg §20.2056(b)-7(d)(1). If the spouse or another trust beneficiary is the executor or a trustee, it may be advisable to include provisions in the estate planning documents that require the beneficiary to utilize an independent party in making any distributions and/or in electing QTIP. This technique also requires states to allow QTIP elections.

Some practitioners have concerns about approaches that use a QTIPable bypass because of Rev Proc 2001-38, 2001-1 Cum Bull 1335. In Rev Proc 2001-38, the IRS stated that it will disregard a QTIP election if no QTIP election was needed to reduce the estate tax to zero. The planner must question whether the revenue procedure refers only to the *federal* tax. According to IRS Letter Ruling 200236021, Rev Proc 2001-38 "was enacted to provide relief for surviving spouses and their estates in situations where a predeceased spouse's estate made an unnecessary qualified terminable interest property (QTIP) election under IRC §2056(b)(7) that did not reduce the estate tax liability." It should be possible to waive the protection of Rev Proc 2001-38 by indicating on Schedule M that the estate elects out of the protection.

NOTE: So far, the IRS has indicated that it will not disregard the election for IRC §1014 purposes when relief is not requested by the executor or trustee. Some commentators question whether the strategy will be equally effective, however, under the terminable interest rules of IRC §1022(c) that will apply to the allocation of the survivor's aggregate basis increase when the estate tax is repealed in 2010. See Hodgman, *Carryover Basis: Planning and Drafting Issues*, 28 Est Plan 611, 615 (2001).

To avoid any problems, it is preferable to provide for division of the trust into separate trusts for the elected and nonelected portion. Then, Rev Proc 2001-38 should not apply because the QTIP portion will be necessary to reduce the tax to zero. The trust document should authorize the division in a manner that satisfied regulation requirements that division can be accomplished on a fractional share basis, with the assets being allocated between trusts based on fair market value at the time of division. Reg §20.2056(b)-7(b)(2)(ii)(B)-(C).

© The Regents of the University of California

§5.21 d. Wait and See

The client may choose to wait and see. With this option, the client would fund a bypass trust with the lesser of the federal or state exclusion amounts. Although this may give rise to tax on the second death, it defers taxation. It also is less complex and avoids administration of extra trusts and/or complicated elections. Due to the rapid increases in the federal exemption amounts, no federal taxes may be owed anyway on the surviving spouse's death.

NOTE: If the client selects this option, it may be prudent to "paper the file" in order to memorialize the planner's advice and the client's decision.

© The Regents of the University of California

§5.22 e. Disclaimer

A disclaimer can be combined with the wait-and-see technique. It gives the surviving spouse the option on the first death to disclaim an amount equal to the state exclusion amount if he or she doesn't want to pay state tax or deal with the complexities inherent in the other options. Alternatively, the amount equal to the federal exclusion can be disclaimed and state tax paid.

There are disadvantages to using a disclaimer trust as an alternative to a bypass trust, including the risk that there will be an inadvertent failure to meet the stringent IRC §2518 requirements for a valid disclaimer. Also, a surviving spouse may not agree with the predeceased spouse's disposition, particularly in second marriages, and thus will fail to utilize a disclaimer. See Drafting California Revocable Trusts, chap 14 (4th ed Cal CEB 2003).

© The Regents of the University of California

§5.23 f. Pay Tax

Depending on the amount of state death tax due, some clients may elect to pay the state tax. This alternative avoids the taxation of income from the QTIP portion of the bypass trust in the survivor's estate. Like the wait-and-see approach, additional trust administration and complexity is avoided. This technique also alleviates the concern of bypass trust depletion due to mandatory income payments to spouse.

© The Regents of the University of California

§5.24 V. ADDITIONAL RAMIFICATIONS OF STATE TAX CREDIT PHASE-OUT

The elimination of the state death tax credit may be beneficial for some California estates. Changes in the IRC §2011 credit affect the amount of credit for previously taxed property because of the reference to IRC §2011 in IRC §2013(c)(1)(A). On January 1, 2005, the reference was eliminated due to the repeal of the IRC §2011 credit. The result is an increase in the IRC §2013 credit both before and after January 1, 2005, because the IRC §2013(c) limitation is reduced. Similarly, the elimination of the IRC §2011 credit means that IRC §6166, permitting an extension of time to pay estate tax attributable to a closely held business, can apply to the entire estate tax. See IRC §2058(b)(2)(B).

© The Regents of the University of California

§5.25 VI. TAX APPORTIONMENT

When a client's estate includes property in another state, it is generally advisable to include a provision in the will or trust concerning the source of funds that will be used to pay the various taxes and the persons responsible. The California apportionment statute applies only to federal and California estate taxes. Prob C §20100(a). After 2005, California estate taxes no longer exist. The out-of-state statute may also come into play, and property passing to a surviving spouse may be looked to for payment of any tax. This is typically contrary to a decedent's wishes. In this light, it is best to tailor tax clauses depending on state of domicile and whether decedent owns property out of state. And as discussed in this chapter, great care must be taken in drafting tax clauses because of state death tax issues. See §5.16A.

© The Regents of the University of California

§5.26 VII. APPENDIX: STATUS OF STATES REGARDING DECOUPLING

State	Status	State Law Source
Alabama	Conformed	Ala Code §40-15-2
Alaska	Conformed	Alaska Stat §43.31.011
Arizona	Conformed; estate and generation-skipping transfer tax provisions repealed and any federal estate taxes paid may be subtracted from personal income taxes; applicable for tax years beginning after Dec, 31, 2005	former Ariz Rev Stat §42 chap 4 (before Jan. 1, 2006); Ariz Rev Stat §43-1332
Arkansas	Conformed	Ark Code Ann §26-59-103
California	Conformed	Rev & T C §§13302, 13411
Colorado	Conformed	Colo Rev Stat §§39-23.5-102, 39-23.5-103
Connecticut	Conformed with special estate tax for decedents dying between July 1, 2004 and Dec. 31, 2004; stand-alone unified estate and gift tax for decedents dying on or after Jan. 1, 2005; tax imposed on estates exceeding $2 million for decedents dying before Jan. 1, 2010, $3.5 million for decedents dying on or after Jan. 1, 2010	Conn Gen Stat §12-391
Delaware	Decoupled—tax frozen at federal credit for state death taxes in effect as of Jan. 1, 2001, for decedents dying after June 30, 2009	Del Code Ann tit 30 §§1501, 1502
Florida	Conformed	Fla Stat Ann §198.02
Georgia	Conformed	Ga Code Ann §48-12-2
Hawaii	Conformed	Haw Rev Stat §§236D-2, 236D-3
Idaho	Conformed	Idaho Code §§14-402, 14-403, 63-3004
Illinois	Decoupled—tax frozen at federal credit for state death taxes in effect on Dec. 31, 2001, for decedents dying between Jan. 1, 2003, and Dec. 31, 2009; tax imposed on estates exceeding EGTRRA applicable exclusion amount through Dec. 31, 2005; tax imposed on estates exceeding $2 million through Dec. 31, 2009; for persons dying after Dec. 31, 2009, tax tied to federal credit for state death taxes	35 Ill Comp Stat §§405/2, 405/3
Indiana	Conformed; inheritance tax	Ind Code §§6-4.1-11-2, 6-4.1-1-4

Iowa	Conformed; inheritance tax	Iowa Code §422.3
Kansas	Decoupled; for persons dying in 2007-2009 tax imposed on estates exceeding $1 million; estate tax repealed effective Jan. 1, 2010	former Kan Stat Ann §§79-15, 101, 79-15, 102 (before Jan. 1, 2007); Kan Stat Ann §§79-15, 203, 79-15, 253
Kentucky	Conformed; inheritance tax	Ky Rev Stat Ann §§140.130, 140.010
Louisiana	Conformed; inheritance tax repealed for deaths occurring after June 30, 2004	La Rev Stat Ann §§47:2431, 47:2432, 47:2401 (repealed Dec. 1, 2010)
Maine	Decoupled—tax frozen at pre-EGTRRA federal credit for state death taxes for decedents dying on or after Jan. 1, 2002; tax imposed on estates exceeding applicable exclusion amount in effect on Dec. 31, 2000	Me Rev Stat Ann Tit 36, §§4062, 4063, 4063-A
Maryland	Decoupled—tax frozen at pre-EGTRRA federal credit for state death taxes; tax imposed on estates exceeding $1 million, effective Jan. 1, 2004; inheritance tax	Md Code Ann Tax-Gen §§7-304, 7-309
Massachusetts	Decoupled—for decedents dying after Dec. 31, 2002, tax frozen at federal credit for state death taxes in effect on Dec. 31, 2000; tax imposed on estates exceeding applicable exclusion amount in effect on Dec. 31, 2000 (including scheduled increases); separate state QTIP election	Mass Gen Laws ch 65C §§2A(a), 3
Michigan	Special case—IRC in effect on Jan. 1, 1998, or, at option of personal representative, in effect on date of decedent's death	Mich Comp Laws §§205.232, 205.256
Minnesota	Decoupled—tax frozen at federal credit for state death taxes in effect on Dec. 31, 2000; tax imposed on estates exceeding $700,000 for decedents dying during 2002 and 2003; $850,000 for decedents dying during 2004; $950,000 for decedents dying during 2005; and $1 million for decedents dying after Dec. 31, 2005	Minn Stat §§291.005, 291.03, 289A.10(1)-(2)
Mississippi	Conformed	Miss Code Ann §27-9-5
Missouri	Conformed	Mo Rev Stat §§145.011, 145.091
Montana	Conformed	Mont Code Ann §§72-16-904, 72-16-905
Nebraska	Decoupled—tax computed using tax rate tables; tax imposed on estates exceeding $1 million for decedents dying before Jan. 1, 2007; estate tax repealed effective Jan. 1, 2007;	Neb Rev Stat §§77-2101, 77-2101.01, 77-2101.03, 49-801.01

	inheritance tax	
Nevada	Conformed	Nev Rev Stat Ann §§375A.025, 375A.100
New Hampshire	Conformed; inheritance tax	NH Rev Stat Ann §§87.1, 87.7
New Jersey	Decoupled—tax frozen at federal credit for state death taxes in effect on Dec. 31, 2001; personal representative can elect to apply either maximum state death tax credit or amount determined under simplified tax system; tax imposed on estates exceeding $675,000 (*i.e.,* applicable exclusion amount in effect on Dec. 31, 2001 (not including scheduled changes)); inheritance tax	NJ Stat Ann §§54:38-1, 54:33-1
New Mexico	Conformed	NM Stat Ann §§7-7-2, 7-7-3
New York	Decoupled—tax frozen at federal credit for state death taxes in effect on July 22, 1998; tax imposed on estates exceeding $1 million	NY Tax Law §§951-952, 960
North Carolina	Decoupled—tax frozen at federal credit for state death taxes in effect on Jan. 1, 2001; tax imposed on estates exceeding EGTRRA applicable exclusion amounts	NC Gen Stat §§105-32.1, 105-32.2, 105-228.90
North Dakota	Conformed	ND Cent Code §57-37.1-04
Ohio	Conformed; separate stand-alone estate tax	Ohio Rev Code Ann §§5731.02, 5731.18
Oklahoma	Conformed; separate stand-alone estate tax until Jan. 1, 2010, when estate tax is repealed; applicable exclusion amount $1 million for decedents dying in 2006 and 2007, $2 million in 2008, and $3 million for 2009	Okla Stat tit 68 §§804, 809
Oregon	Decoupled—tax frozen at federal credit for state death taxes in effect on Dec. 31, 2000; for decedents dying after Dec. 31, 2002, tax imposed on estates exceeding applicable exclusion amount in effect on Dec. 31, 2000 (including scheduled increases)	Or Rev Stat §§118.007, 118.005(10), 118.009, 118.010, 118.160
Pennsylvania	Recoupled/Conformed; inheritance tax	72 Pa Cons Stat §§9102, 9117
Rhode Island	Decoupled—tax frozen at federal credit for state death taxes in effect on Jan. 1, 2001; for decedents dying on or after Jan. 1, 2002, but before Jan. 1, 2010, tax imposed on estates exceeding applicable exclusion amount in effect on Jan. 1, 2001 (not including scheduled increases); for decedents dying on or after Jan. 1, 2008,	RI Gen Laws §44-22-1.1

	applicable exclusion amount is $850,000 (indexed for inflation)	
South Carolina	Conformed	SC Code Ann §§12-16-510, 12-16-20, 12-6-40
South Dakota	Conformed	SD Codified Laws §§10-40A-1, 10-40A-3
Tennessee	Conformed; inheritance tax	Tenn Code Ann §§67-8-202, 67-8-203
Texas	Conformed	Tex Tax Code Ann §§211.001, 211.003, 211.051
Utah	Conformed	Utah Code Ann §59-11-102, 59-11-103
Vermont	Decoupled—tax frozen at federal credit for state death taxes in effect on Jan. 1, 2001; tax imposed on estates exceeding EGTRRA applicable exclusion amounts	Vt Stat Ann Tit 32 §§7402(8), 7442a, 7475
Virginia	Decoupled—tax frozen at federal credit for state death taxes in effect on Jan. 1, 2001; tax imposed on estates exceeding EGTRRA applicable exclusion amounts in effect on Jan. 1, 2008	Va Code Ann §§58.1-901, 58.1-902
Washington	Conformed; effective May 17, 2005, separate stand-alone estate tax that incorporates IRC as of Jan. 1, 2005	Wash Rev Code §§83.100.020, 83.100.040
West Virginia	Conformed	W Va Code §11-11-3
Wisconsin	Decoupled—for deaths occurring after Sept. 30, 2002, and before Jan. 1, 2008, tax frozen at federal credit for state death taxes in effect on Dec. 31, 2000; tax imposed on estates exceeding applicable exclusion amount in effect on Dec. 31, 2000 (not including scheduled increases) Conformed for deaths occurring after Dec. 31, 2007; tax tied to federal credit for state death taxes; tax imposed on estates exceeding EGTRRA applicable exclusion amounts	Wis Stat §§72.01, 72.02
Wyoming	Conformed	Wyo Stat Ann §§39-19-103, 39-19-104
District of Columbia	Decoupled—tax frozen at federal credit for deaths occurring on or after Jan. 1, 2002, and any increases provided in IRC §2010 will not apply. The unified credit will be $220,550, imposing tax on estates exceeding $675,000. The same applies to deaths on or after Jan. 1, 2003, but the unified credit will be $345,800, imposing tax on estates exceeding $1	DC Code Ann §§47-3701, 47-3702

	million for deaths occurring on or after Jan. 1, 2003	

© The Regents of the University of California

6

Estate Planning for Companion Animals/Pets

Elizabeth Anne Bird

I. OBJECTIVES OF ESTATE PLANNING FOR COMPANION ANIMALS §6.1

II. USING A TRUST TO PROVIDE FOR COMPANION ANIMALS
- A. Statutory Authority and Requirements
  - 1. Statutory Authority §6.2
  - 2. Statutory Requirements
    - a. Distribution Requirements §6.2A
    - b. Enforcement and Reporting Requirements §6.2B
- B. Advantages of Using a Trust §6.3
- C. Preliminary Considerations
  - 1. Assets to Fund Companion Animal Trust §6.4
  - 2. Trustee Duties and Fees §6.4A
  - 3. Cost of Custom Drafting §6.5

III. ALTERNATIVES TO COMPANION ANIMAL TRUST
- A. Outright Gift §6.6
  - 1. Form: Outright Gift in Will §6.7
  - 2. Form: Outright Gift in Trust Agreement §6.8
- B. Animal Protection Organizations
  - 1. Outright Gift to Animal Protection Organization §6.9
  - 2. Form: Outright Gift to Animal Protection Organization §6.10

IV. DRAFTING COMPANION ANIMAL TRUST PROVISIONS
- A. Roles of Trustee and Caretaker §6.11
  - 1. Form: Trustee Provisions §6.12
  - 2. Form: Appointment of Caretaker §6.13
- B. Providing for Specific Companion Animals Versus Any Surviving Companion Animals §6.14
  - 1. Providing Specific Care Instructions §6.15
  - 2. Form: Instruction Not to Separate Companion Animals §6.16
- C. Provisions for Settlor's Incapacity §6.17
  - 1. Form: Care for Companion Animals in Case of Settlor's Incapacity §6.18
  - 2. Funding Trust on Settlor's Incapacity §6.19
- D. Funding Companion Animal Trust §6.20
  - 1. Form: Specific Distribution to Companion Animal Trust §6.21
  - 2. Form: Distribution of Trust Residue to Companion Animal Trust §6.22
- E. Expenses for Care of Companion Animal §6.23
- F. Caretaker and Trustee Fees §6.24
- G. Veterinarian Information
  - 1. Including Information in Trust §6.25
  - 2. Form: Veterinarian Information §6.26
- H. Distribution on Termination of Companion Animal Trust
  - 1. Designating Remainder Beneficiary §6.27
  - 2. Form: Distribution of Residue to Charity §6.28
- I. Tax Issues
  - 1. Income Tax Consequences §6.29
  - 2. No Charitable Deduction §6.30
  - 3. Form: Remainder Gift Does Not Qualify for Charitable Deduction §6.31

V. CHECKLIST FOR CLIENT INTERVIEW §6.32

VI. SAMPLE TRUST PROVISIONS §6.33
- A. Form: Sample Provisions for Single Settlor's Trust, With Provisions for Care of Companion Animals §6.34
- B. Form: Sample Provisions for Married Couple's Trust, Revised to Provide for Care of Companion Animals §6.35

© The Regents of the University of California

§6.1 I. OBJECTIVES OF ESTATE PLANNING FOR COMPANION ANIMALS

Whether you call them pets or companion animals (as we do in this chapter), they play an important part in the lives of many people. Frequently owners of companion animals want to arrange for the financial support and care of their animals if they become unable to personally provide for that care. Estate planning provisions that provide for companion animals that outlive the client can be included in the client's will or trust agreement. Existing estate planning documents can be amended to add these provisions.

A durable power of attorney or the dispositive provisions of a revocable living trust also can be used to ensure that companion animals will be properly cared for if the owner becomes disabled or until the long-term plan takes effect. See California Durable Powers of Attorney §§4.3-4.4 (Cal CEB 1996); Drafting California Revocable Trusts §6.21 (4th ed Cal CEB 2003).

© The Regents of the University of California

II. USING A TRUST TO PROVIDE FOR COMPANION ANIMALS

A. Statutory Authority and Requirements

§6.2 1. Statutory Authority

An outright gift to an animal is void. In *Estate of Russell* (1968) 69 C2d 200, 70 CR 561, the court found that the testatrix's dog, Roxy Russell, could not be a beneficiary of a will under former Prob C §7 (see now Prob C §6102), which limited disposition of property to "any person." Although "person" is defined to include individuals, corporations, and charities, the court held that a dog was not an eligible beneficiary and directed distribution of Roxy's share (half of the estate) to the decedent's heirs at law. After the *Russell* case, there was much uncertainty among estate planning attorneys about how to ensure the proper care of a client's companion animals.

In 1991, the legislature enacted former Prob C §15212, which permitted trusts for the care of "a designated domestic or pet animal" to be performed by the trustee for the animal's lifetime, regardless of whether there was a beneficiary who could seek enforcement of the trust and regardless of whether the trust terms contemplated a longer duration. Although former Prob C §15212 clarified that such trusts were permissible, they notably could lack the enforcement mechanism of a private trust, namely a current beneficiary who could take action against a trustee who failed to administer the trust according to its terms.

To address this and other perceived shortcomings, effective January 1, 2009, former Prob C §15212 was repealed and replaced by a new version of Prob C §15212. Under the new §15212, subject to the requirements of the statute (see §§6.2A-6.2B) a trust for the care of an animal meeting the requirements is a trust for a lawful noncharitable purpose. Prob C §15212(a). The trust instrument must be liberally construed to bring the trust within the scope of the statute, to presume against interpreting it as merely precatory or honorary, and to carry out the settlor's general intent. Prob C §15212(a).

Note that Prob C §15212 limits the definition of "animal" to mean a "domestic or pet animal." Prob C §15212(i). The statute does not define "domestic or pet animal."

AUTHOR'S ADVICE: California gives specific legislative protection to trusts established to benefit a domestic or pet animal. A client who moves out of California should consult local counsel to determine whether the estate plan must be modified in the client's new place of residence to provide for companion animals. For a brief overview of pet trust statutes in selected other states, see Hirschfeld, *Pet Trusts Offer Elderly Clients Peace of Mind*, 18 Elder Law Report 1 (Feb. 2007).

© The Regents of the University of California

2. Statutory Requirements

§6.2A a. Distribution Requirements

Unless the trust instrument expressly provides otherwise, the principal or income of a trust for the care of an animal under Prob C §15212 cannot be converted to the use of the trustee or to any use other than for the animal's benefit. Prob C §15212(b)(1).

The trust terminates on the death of the last animal for which it has been established that was alive on the date of the settlor's death. Prob C §15212(a). It is not subject to the termination provisions of Prob C §15408 (termination by trustee if principal does not exceed $20,00) or Prob C §15211 (21-year limit on honorary trusts). Prob C §15212(g)-(h).

On termination of the trust, the trustee must distribute remaining trust property in the following order (Prob C §15212(b)(2)):

(1) As directed in the trust instrument;

(2) If the trust was created in a nonresiduary clause in the settlor's will or in a codicil to the will, under the residuary clause in the will;

(3) If unexpended trust property remains, to the settlor's heirs under Prob C §21114.

© The Regents of the University of California

§6.2B b. Enforcement and Reporting Requirements

A person designated in the trust instrument or, if none is designated, a person appointed by the court, can enforce the intended use of the principal or income of a trust for the care of an animal. Prob C §15212(c). Any trustee or beneficiary of the trust, person interested in the animal's welfare, or nonprofit animal welfare organization may petition the court regarding the affairs of the trust under Prob C §§17200-17211. Prob C §15212(c).

If a trustee is not designated, or if no designated or successor trustee is willing or able to serve, the court will name one. Prob C §15212(d). The court can order the transfer of the trust property to the court-appointed trustee, if this is required to ensure that the trust purposes are carried out. Prob C §15212(d). The court can also make any other orders and determinations that it deems advisable to carry out the settlor's intent and the purposes of Prob C §15212. Prob C §15212(d).

The trustee must provide accountings as required by Prob C 16062 to the beneficiaries who would be entitled to distribution if the animal were deceased at the time and to any nonprofit charitable corporation that has as its principal activity the care of animals and has made a written request. Prob C §15212(e). This requirement is, however, subject to an exception that extends to other trustee duties and rights as well: if the value of the trust assets does not exceed $40,000, no periodic accounting, filing, report, registration, separate maintenance of funds, appointment, or trustee fee is required because of the trustee's fiduciary relationship, unless ordered by the court or required by the trust instrument. Prob C §15212(e). See §6.4A.

Any beneficiary, any person designated by the trust instrument or court to enforce the trust, or any nonprofit charitable corporation that has as its principal activity the care of animals may, on reasonable request, inspect the animal, the premises where it is kept, and the books and records of the trust. Prob C §15212(f).

© The Regents of the University of California

§6.3 B. Advantages of Using a Trust

A trust generally provides the best option for the care of a settlor's companion animal. A gift to a trust for the benefit of one or more companion animals can provide a flexible method for managing financial assets for the benefit of the companion animals that survive the settlor, until the last surviving animal dies. At that time, any remaining financial assets in the trust for companion animals can be distributed in accordance with the settlor's wishes as directed in the trust document. Prob C §15212(b)(2). An animal protection organization, *e.g.,* the local chapter of the Society for the Prevention of Cruelty to Animals or the Humane Society, can be designated as a remainder beneficiary, if desired. See §6.9.

Another advantage of a trust is that the trust provisions can include very specific instructions for the care of the companion animals. See §6.15.

The settlor should nominate a trustworthy and suitable caretaker (and alternatives) or instruct the trustee regarding the trustee's responsibility for finding suitable caretakers and homes for the companion animals. The settlor can instruct the trustee to pay for all expenses related to the proper care of the companion animals and direct the trustee to visit the companion animals periodically.

A companion animal trust agreement should provide for the payment of all final medical and disposition expenses and can include any special instructions the client may have concerning the arrangements after each companion animal's death.

A client's will can be used to fund a testamentary companion animal trust. However, if the client sets up a living trust, the living trust can include provisions for the care of companion animals throughout the client's lifetime, during any period that the client is unable to care for the companion animals, *e.g.*, due to incapacity. See §6.17. A living trust also eliminates any delay between the client's death and funding of a testamentary companion animal trust.

AUTHOR'S ADVICE: Establishing any companion animal trust requires a leap of faith. The settlor hopes that the trustee will carry out the trust as instructed and will spend trust funds in ways beneficial to the intended beneficiaries of the trust. Despite the reassuring enforcement language in Prob C §15212, clients should be reminded that although establishing a companion animal trust is a thoughtful and legal way to provide for a companion animal's needs in the event that the settlor becomes incapacitated or dies, there is the real life risk that the trust funds will be misappropriated. Court enforcement may not be available in a timely manner. There may be no interested person with the sufficient assets to petition the court for proper enforcement of the trust.

© The Regents of the University of California

C. Preliminary Considerations

§6.4 1. Assets to Fund Companion Animal Trust

Drafting a trust for a companion animal is not unlike drafting a trust for a client to provide for a minor child or an adult. Generally, the companion animal trust will be funded at the client's death. The client must decide how much money or what portion of the client's estate to allocate to the trust to provide financial support for one or more of the client's companion animals for their lifetimes. Factors the client must consider include:

- The kind of animal;
- Its life expectancy (for life expectancies of various companion animals, see http://www.petplace.com);
- The standard of living the client wants to provide; and
- The size of the client's estate.

AUTHOR'S ADVICE: It is not advisable to draft a separate companion animal trust unless the client is willing and able to set aside sufficient assets to be used solely for the care and support of surviving companion animals for as long as they live. The sum of $10,000-50,000 per companion animal expected to survive, depending on the type of animal, might be an appropriate minimum amount to make the funding and administration of a separate companion animal trust feasible.

© The Regents of the University of California

§6.4A 2. Trustee Duties and Fees

As noted in §6.2B, if the value of the trust assets does not exceed $40,000, periodic accountings, separate maintenance of funds, and trustee fees are not required unless ordered by the court or required by the trust instrument. Prob C §15212(e).

In the author's opinion, however, the purpose of establishing a separate companion animal trust is to ensure that (1) assets are segregated and (2) sufficiently detailed records are kept to allow an interested party to review income and disbursements to ensure that assets are being properly administered for the animal beneficiaries, and to enable the trustee to prepare the type of account required by Prob C §16062 if the court orders one. A trustee who performs these services should be paid a reasonable fee. Thus, it is recommended that the companion animal trust contain specific language regarding segregation of trust funds, accounting information, and trustee fees to counter any potentially adverse results under Prob C §15212(e). See §6.12 for sample trust provision.

© The Regents of the University of California

§6.5 3. Cost of Custom Drafting

Obtaining necessary information and preparing the necessary custom drafting of the companion animal trust in order to address the client's specific concerns will generally add substantial time to preparing the client's estate planning documents. Ascertain that the client is willing to pay for the extra work before agreeing to add these provisions.

© The Regents of the University of California

III. ALTERNATIVES TO COMPANION ANIMAL TRUST

§6.6 A. Outright Gift

If a responsible, trustworthy individual has agreed to care for the client's companion animals, the client may decide to make an outright gift of the companion animals and funds for their care to the proposed caretaker. The gift can be made either in a will or a revocable trust. For form language, see §§6.7-6.8, 6.10.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.7 1. Form: Outright Gift in Will

§6.7 1. Form: Outright Gift in Will

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.7-1 Outright gift in will

I give my companion animals that survive me to _ _[*name of caretaker and relationship, e.g., my cousin, my friend, my landlady*]**_ _, presently residing at _ _**[*address*]**_ _, if _ _**[*name*]**_ _ agrees to take custody of my companion animals and provide for their care. If _ _**[*name*]**_ _ is unable or unwilling to do so, I give my companion animals that survive me to _ _**[*name of alternate caretaker and relationship, e.g., my cousin, my friend, my landlady*]**_ _, presently residing at _ _**[*address*]**_ _, if _ _**[*name*]**_ _ agrees to take custody of my companion animals and provide for their care. If all named individuals are unable or unwilling to accept these responsibilities, I direct my executor to find another individual willing to take custody of my companion animals and provide for their care and I give my companion animals to that individual.**

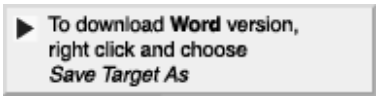
I direct my executor to give _ _[*dollar amount*]**_ _ from my estate to the individual who accepts my companion animals, and I request (but do not direct) that these funds be used for the care of my animals. If my executor chooses more than one individual, my executor, in the executor's discretion, may divide the gift of _ _**[*dollar amount*]**_ _ among those individuals. If none of my companion animals survive me, this gift will lapse.**

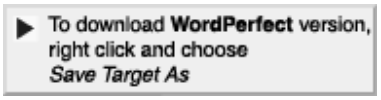
Comment: Including information about the caretaker's relationship to the client can be very helpful when the person administering the estate or trust needs to find the people designated in the document.

The forms assume that the funds are given solely to provide for the companion animals' care. If the client wants the proposed caretaker to receive the funds whether or not any of the companion animals survive the client, the form should be modified.

© The Regents of the University of California

§6.8 2. Form: Outright Gift in Trust Agreement





6.8-1 Outright gift in trust agreement

The trustee is directed to give the settlor's companion animals then living and _ _[*dollar amount*]_ _ to _ _[*name of individual and relationship, e.g., my cousin, my friend, my landlady*]_ _, if _ _[*name*]_ _ agrees to take custody of the settlor's surviving companion animals and provide for their care. If _ _[*name*]_ _ is unable or unwilling to do so, the trustee is directed to give the settlor's companion animals then living and _ _[*dollar amount*]_ _ to _ _[*name of alternate individual and relationship, e.g., my cousin, my friend, my landlady*]_ _, if _ _[*name*]_ _ agrees to take custody of the settlor's surviving companion animals and provide for their care. If _ _[*name*]_ _ and _ _[*name*]_ _ are unable or unwilling to do so, the trustee is directed to find another individual willing to take custody of the companion animals and provide for their care. If the trustee chooses more than one individual, the trustee, in the trustee's discretion, may divide the gift of _ _[*dollar amount*]_ _ among those individuals. If none of the companion animals are then living, this gift will lapse.

Comment: The forms assume that the funds are given solely to provide for the companion animals' care. If the client wants the proposed caretaker to receive the funds whether or not any of the companion animals survive the client, the form should be modified.

© The Regents of the University of California

B. Animal Protection Organizations

§6.9 1. Outright Gift to Animal Protection Organization

Clients who do not wish to have a friend or relative care for their companion animals may prefer to name an organization as caretaker. A number of California animal protection organizations have programs that provide permanent care or guarantee placement of companion animals when their owners die or become disabled. For example, the San Francisco Society for the Prevention of Cruelty to Animals (SPCA) has a program available to members called the Sido Service. To enroll companion animals in the Sido program, SPCA members must include language in their estate planning documents giving their companion animals to the SPCA. For sample provision, see §6.10.

The SF SPCA also asks donors to fill out a pet biography form to help the SPCA find a suitable placement. If any enrolled companion animals survive the member, the SPCA will arrange for their adoption in a suitable home. For more details regarding the Sido program, look at the SF SPCA's website at http://www.sfspca.org.

Other animal protection organizations that provide similar adoption services or permanent care include:

- Animal Rescue Foundation—Guardian Program (Walnut Creek) http://www.arf.net
- Berkeley East Bay Humane Society—Caretaker Program (Berkeley) http://www.berkeleyhumane.org/Community/Community_Services.htm
- California Cat Center, Inc.—Lifecare Program (San Fernando Valley) http://www.californiacatcenter.com
- East Bay SPCA—Pet Survivor Placement Program (Oakland, Dublin) http://www.eastbayspca.org
- Friends of Cats, Inc.—Lifetime Care (El Cajon) http://www.friendsofcats.org
- Helen Woodward Animal Center (Rancho Santa Fe) http://www.animalcenter.org/donate/planned_giving.aspx
- Humane Society of Marin County—Guardians for Life Program (Novato) http://www.marin-humane.org/ProgramsServices/Guardians.html
- National Cat Protection Society—Retirement (Newport Beach, Spring Valley) http://www.natcat.org/retirement.html
- Friends for Life at the North County Humane Society (San Luis Obispo) http://www.slonchs.org/programs.html
- Hopalong Animal Rescue Pet Survivor (HARPS)—Pet Survivor Program (Oakland) http://www.hopalong.org
- Pet Pride (Los Angeles) http://www.petpride.org/support.htm
- Pets in Need—Guardian Program (Redwood City) http://www.petsinneed.org/Referrals.html
- SPCA of Monterey—Guardian Angel Future Care Program (Monterey) http://www.spcamc.org/guardian_angel.htm
- UC Davis School of Veterinary Medicine—Tender Loving Care for Pets (Davis) http://www.vetmed.ucdavis.edu/ccah/tlc
- Valley Animal Center—No Kill Shelter (Fresno) http://www.valleyanimal.org

Some of these organizations ask participants to make a planned gift to the organization in their estate planning documents. Even if a gift is not required, the client might be interested in adding a financial gift to the named animal protection organization in the client's estate planning documents. These organizations rely on public donations to support their work and always appreciate gifts.

NOTE: Of course, Probate Code drafting requirements must be satisfied. For example, in *Estate of Southworth* (1996) 51 CA4th 564, 59 CR2d 272, the court held that when the decedent checked a box on a donor card that stated "I am not taking action now but my intent is," and filled in the blank with the handwriting "My entire estate is to be left to" the animal protection organization, the card did not satisfy the requirements for a holographic will.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.10 2. Form: Outright Gift to Animal Protection Organization

§6.10 2. Form: Outright Gift to Animal Protection Organization

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.10-1 Outright gift to animal protection organization

I currently have _ _[*specify number of companion animals and species*]_ _**, namely,** _ _[*specify names, ages, or birth dates, breeds and/or physical descriptions of companion animals*]_ _**. I give all companion animals I then have to the** _ _[*name of animal protection organization*]_ _**, currently located at** _ _[*address*]_ _**, to be placed in loving homes in accordance with the program provided by the** _ _[*name of organization*]_ _**.**

Comment: This form can be used in a will or a living trust. The provision is appropriate to be effective on the client's death. However, the trustee of a living trust could also refer to this provision as an indication of the settlor's wishes if the settlor becomes unable to care for the animals and is unlikely to regain the capacity to do so.

© The Regents of the University of California

IV. DRAFTING COMPANION ANIMAL TRUST PROVISIONS

§6.11 A. Roles of Trustee and Caretaker

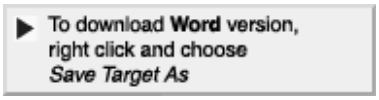
"Caretaker" is the term used in this chapter for the person with whom the companion animal will live. When the trust is funded with a minimal amount, the trustee may be the best and most obvious person to serve as caretaker. The client should be cautioned, however, that he or she must have confidence in the trustee's willingness and ability to care for the animal if the trustee is also allowed to serve as caretaker. Allowing the trustee to serve as caretaker sets up a conflict of interest, removes any checks on the caretaker's performance, and thus could undermine the purpose of the trust.

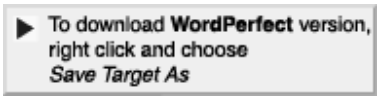
The trustee will administer the financial assets held in the companion animal trust, and distribute income and principal as provided by the trust document. Generally, the trustee should be made responsible both for managing the financial assets used to care for the companion animals and for supervising the caretaker's care of the companion animals. If the client has a living trust, the trustee of the living trust can serve as trustee of the companion animal trust, or a separate trustee of the companion animal trust can be named. See discussion of the trustee's role and fees in §6.4A.

The initial caretaker and successor caretakers can be appointed in the companion animal trust. Alternatively, the client can give the estate planning attorney a written list of preferred caretakers and in the trust agreement simply direct the trustee to choose a caretaker in the trustee's discretion. Generally, it is a good idea to give the trustee the power to remove a caretaker, if the caretaker is not providing adequate care for the animals, and the power to appoint a new caretaker.

© The Regents of the University of California

§6.12 1. Form: Trustee Provisions





6.12-1 Trustee provisions

[*Use one of the following alternatives*]

[*Alternative 1: Companion animal trustee same as main trustee*]

***Trustee*. The trustee of the Companion Animal Trust will be the same as the trustee then serving as the main trustee under this document.**

[*Alternative 2: Separate companion animal trustee nominated*]

***Trustee*. _ _[*Name*]_ _ will serve as the initial trustee of the Companion Animal Trust. If this nominated trustee is or becomes unwilling or unable to serve, _ _[*name of successor trustee*]_ _ will become the trustee. If this nominated successor is unwilling or unable to serve, the trustee then serving as the main trustee under this document will also have the power to appoint a successor trustee of the Companion Animal Trust and will be eligible to serve as the trustee of the Companion Animal Trust.**

[*Continue*]

[*If applicable, add one or both of the following options*]

[*Option 1: Asset segregation, accounting information, and fees*]

So long as the value of the Companion Animal Trust equals or exceeds $_ _[*amount, e.g., $5,000*]_ _ the trustee shall segregate trust assets; maintain books and records for the trust in sufficient detail to permit the preparation of the type of accounting required by Probate Code §16062, in the event such an accounting is required by court order; and be entitled to reasonable fees for services rendered.

[*Option 2: Involvement and oversight of an animal protection organization*]

The trustee is encouraged to arrange for the _ _[*name and address of animal protection organization*]_ _, or its successor organization to have access to the books and records of the Companion Animal Trust. If the trustee is or becomes unwilling or unable to continue to act as trustee of the Companion Animal Trust, the Board of Directors of the _ _[*name of animal protection organization*]_ _ will have the power to appoint a successor trustee.

Comment: Option 1 is recommended to change some of the default provisions of Prob C §15212(e). See §6.4A. The language in Option 2 might be appropriate only if the client is making a financial gift in the client's estate planning documents to the animal protection organization.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.13 2. Form: Appointment of Caretaker

§6.13 2. Form: Appointment of Caretaker

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.13-1 Appointment of caretaker

[*Use one of the following alternatives*]

[*Alternative 1: Caretaker appointed by trustee]*

***Caretaker*. The trustee may serve as a caretaker or must arrange for one or more independent caretakers to provide a home for the settlor's companion animals.**

[*Alternative 2: Caretaker appointed by settlor*]

***Caretaker*. _ _[*Name*]_ _ will serve as the initial caretaker under the Companion Animal Trust. If this nominated caretaker is or becomes unwilling or unable to serve, _ _[*name of successor caretaker*]_ _ will become the caretaker. If this nominated successor is or becomes unwilling or unable to serve, the main trustee serving under this document will have the power to appoint one or more successor caretakers to serve under the Companion Animal Trust _ _[*and will be eligible to serve as the caretaker*]_ _.**

[*Continue*]

The trustee may remove and replace the caretaker in the trustee's discretion.

© The Regents of the University of California

§6.14 B. Providing for Specific Companion Animals Versus Any Surviving Companion Animals

Probate Code §15212 describes a trust for the care of "an animal." Often, however, companion animal trusts are drafted to provide for more than one animal. Although the client may focus on providing only for one or more current companion animals, the attorney should ask the client to consider naming existing companion animals in the estate planning documents, as well as including provisions that apply generically to the client's "companion animals."

Generally it is advisable to set up the companion animal provisions to provide for all companion animals that the client may have in the future, because the client may have different companion animals when he or she dies or becomes disabled. These provisions will cover future losses of companion animals and adoptions of new ones. Clients who want to provide for current companion animals also are likely to want to provide for companion animals they may acquire in the future. If a generic companion animal trust is used, the trust can last until the death of the last companion animal that survives the settlor. The sample trusts for single and married settlors in this chapter incorporate this approach. See §§6.34-6.35.

NOTE: A companion animal trust that provides for the care of all companion animals that survive the settlor as a class is specifically authorized under Prob C §15212(a).

© The Regents of the University of California

§6.15 1. Providing Specific Care Instructions

The client may wish to include directions for the care of specific companion animal beneficiaries, *e.g.,* instructions to place certain animals together. See §6.16. Often, the owner may have specific instructions regarding veterinary care, feeding, dietary restrictions, or other special care instructions, *e.g.,* regarding allergies. These provisions can be included in the companion animal trust to ensure compliance or can be provided as guidance in writing by the client in the client's estate planning file. The checklist in §6.32 suggests keeping separate written instructions for cost-effectiveness and the ease of updating.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.16 2. Form: Instruction Not to Separate Companion Animals

§6.16 2. Form: Instruction Not to Separate Companion Animals

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.16-1 Instruction not to separate companion animals

Living Arrangements. **If both _ _[*name of animal*]_ _ and _ _[*name of animal*]_ _ are then living, the trustee should make arrangements so that _ _[*name of animal*]_ _ and _ _[*name of animal*]_ _can continue to live together, if feasible.**

© The Regents of the University of California

§6.17 C. Provisions for Settlor's Incapacity

Planning for companion animal care should include arrangements in the event the settlor becomes incapacitated. Either a living trust or a durable power of attorney for financial management can be used to ensure that financial support will be available for the settlor's companion animal care during any time when the settlor is incapacitated. However, using a living trust is preferable, because the trust agreement can direct the trustee to take responsibility for the settlor's then living companion animals and to use trust assets to provide for the companion animals in accordance with the provisions of the companion animal trust. When the settlor dies, the companion animal trust is funded as a separate trust. Typically, a living trust will provide for appointment of a successor trustee to manage trust assets if the settlor/trustee becomes incompetent.

For discussion of determining the competence of the settlor, see Drafting California Revocable Trusts §§6.11-6.12 (4th ed Cal CEB 2003); on removing an incompetent settlor who is acting as trustee, see Revocable Trusts §16.39. For durable power of attorney for financial management (DPAF) authorizing the agent to arrange for the care, veterinary treatment, and disposition of the principal's companion animals, see California Powers of Attorney and Health Care Directives §4.4 (Cal CEB 2008); this book as a whole provides complete coverage of durable powers.

© The Regents of the University of California

§6.18 1. Form: Care for Companion Animals in Case of Settlor's Incapacity

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.18-1 Care for companion animals in case of settlor's incapacity

Companion Animal Care During Settlor's Incapacity. **During any period when the settlor is incompetent to make requests, the trustee will distribute single sums or periodic payments out of the trust estate to support the settlor's then living companion animals in the same manner and in accordance with the provisions set forth in the Companion Animal Trust in this document (adjusted if necessary by circumstances).**

Comment: For a complete durable power of attorney for personal care to which this companion animal provision can be added, see California Powers of Attorney and Health Care Directives §§5.69-5.70 (Cal CEB 2008).

© The Regents of the University of California

§6.19 2. Funding Trust on Settlor's Incapacity

Alternatively, a living trust could provide that the companion animal trust is to be funded on the settlor's incapacity. However, this alternative lacks the flexibility of simply allowing the trustee to provide trust financial assets for the proper care of the settlor's then living companion animal when and as needed during the lifetime of the settlor. Additionally, if a companion animal trust is funded on the settlor's incapacity, trust assets could be exhausted during the settlor's lifetime, leaving no financial assets to support the companion animals that survive the settlor. See also §6.4 on the advisability of drafting a separate companion animal trust.

© The Regents of the University of California

§6.20 D. Funding Companion Animal Trust

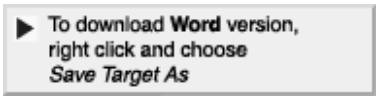
The distribution plan must describe how the trust estate will be used to fund the companion animal trust. Generally, it is better to describe the gift to fund the companion animal trust in terms of a dollar amount, or a percentage or a share of the residue of the trust estate.

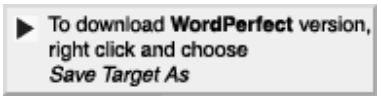
AUTHOR'S ADVICE: Avoid tying the gift to the income of an asset or to a home that may not exist when the gift or trust will be funded.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.21 1. Form: Specific Distribution to Companion Animal Trust

§6.21 1. Form: Specific Distribution to Companion Animal Trust





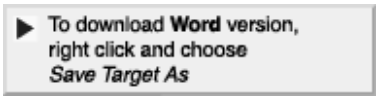
6.21-1 Specific distribution to companion animal trust

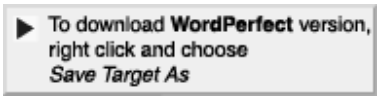
***Distribution to Companion Animal Trust*. The trustee will distribute _ _[*specify dollar amount*]_ _ to the trustee of the Companion Animal Trust. If none of the settlor's companion animals survive the settlor, this gift will lapse.**

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.22 2. Form: Distribution of Trust Residue to Companion Animal Trust

§6.22 2. Form: Distribution of Trust Residue to Companion Animal Trust





6.22-1 Distribution of trust residue to companion animal trust

***Distribution of Residue*. The residue of the trust property, including any lapsed gifts not otherwise disposed of, will be distributed** _ _[*if gift of residue will be divided, specify percentages or shares and other beneficiaries*]_ _ **to the trustee of the Companion Animal Trust. If none of the settlor's companion animals survive the settlor, this gift will lapse.**

© The Regents of the University of California

§6.23 E. Expenses for Care of Companion Animal

The companion animal trust should provide for payment of all expenses related to the proper care of the companion animal, leaving the determination of what proper care is and the expenses for which the caretaker will be reimbursed to the trustee's discretion (unless the client has different wishes; see §6.15 for specific care instructions). The trust should authorize the trustee, in the trustee's discretion, to make fixed monthly payments to the caretaker and reimburse the caretaker for out-of-pocket expenses, and to directly pay third parties who provide services and products for the companion animal. See §§6.34-6.35.

© The Regents of the University of California

§6.24 F. Caretaker and Trustee Fees

As the required services are unpredictable, it is generally not a good idea to direct set fees for the caretaker and/or trustee. Fees for the caretaker can be determined in the trustee's discretion. Trustee fees can be specified in the trust instrument to be reasonable under the circumstances. See Prob C §§15212(e), 15681. See also §6.4A. If a trust company is serving as trustee, trustee fees are generally charged in accordance with the trust company's existing schedule for services. See generally California Trust Administration, chap 9 (2d ed Cal CEB 2001).

© The Regents of the University of California

G. Veterinarian Information

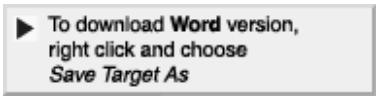
§6.25 1. Including Information in Trust

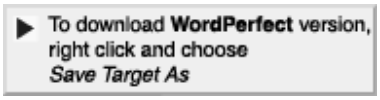
It is a good idea to name the client's current veterinarian in the companion animal trust agreement and to provide contact information, as the companion animal's health records will likely be there. However, the caretaker should have discretion to choose a new veterinarian. The client may also wish to involve the veterinarian in the companion animal's continued care.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.26 2. Form: Veterinarian Information

§6.26 2. Form: Veterinarian Information





6.26-1 Veterinarian information

***Veterinarian*. _ _**[*Name of veterinarian, address, telephone number*]**_ _ is the settlor's current veterinarian. The caretaker may remove and replace the veterinarian in the caretaker's discretion.**

[*If desirable, add one or more of the following options*]

[*Option 1: Preference for current veterinarian*]

The settlor would prefer that _ _[*name of veterinarian*]**_ _ continue to be used as the veterinarian for the settlor's companion animals, but the caretaker may remove and replace the veterinarian in the caretaker's discretion.**

[*Option 2: Veterinarian's advice on selecting caretaker*]

The trustee is encouraged to seek assistance from _ _[*name of veterinarian*]**_ _ in locating suitable caretakers for the settlor's companion animals.**

© The Regents of the University of California

H. Distribution on Termination of Companion Animal Trust

§6.27 1. Designating Remainder Beneficiary

The companion animal trust should specify how the trustee is to distribute any property remaining in the trust on the death of the last companion animal. See Prob C §15212(b)(2). The client may want any remaining companion animal trust property to be distributed in the same manner as the residue of the probate estate or the property of the living trust. The remaining property can also be distributed to the last caretaker, if the client is confident that this would not create an undue conflict of interest.

AUTHOR'S ADVICE: The more funds spent to provide for the companion animals, the less that will remain to benefit the remainder beneficiary. Because of this inherent conflict of interest, a client who wants to reward the caretaker might be better advised to provide for an annual financial gift for the caretaker, rather than making the caretaker the remainder beneficiary of the trust.

Another option is for the trust to provide for distribution of any remaining property to a named animal protection organization. See §6.28. If the remainder beneficiary is to be an animal protection organization, the client may wish to give that organization the power to supervise trust administration. See optional language in form 6.12-1.

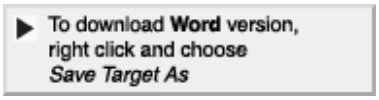
NOTE: The remainder beneficiary will also have the power to enforce the companion animal trust. However, a remainder beneficiary other than an animal protection organization may have little incentive to enforce the trust if doing so would require that more money be spent to provide adequate care for the settlor's companion animals.

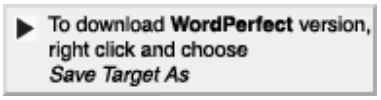
If the companion animal trust does not specify how any property remaining in the trust on the death of the last companion animal should be distributed, and the unexpended property does not pass under the residuary clause of the settlor's will or in a codicil to the settlor's will, then it will pass to the settlor's heirs under Prob C §21114. Prob C §15212(b)(2).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.28 2. Form: Distribution of Residue to Charity

§6.28 2. Form: Distribution of Residue to Charity





6.28-1 Distribution of residue to charity

To _ _[*name and address of animal protection organization*]_ _, or its successor organization. If _ _[*name of animal protection organization*]_ _ is not in existence and has no successor organization, the trustee must distribute the remaining assets of the Companion Animal Trust to one or more similar charitable organizations as the trustee may select in his or her discretion. Any organization selected by the trustee must be an organization described in Internal Revenue Code §2055(a).

© The Regents of the University of California

I. Tax Issues

§6.29 1. Income Tax Consequences

A companion animal trust that is valid under state law is subject to income tax under IRC §§1(e) and 641, not the caretaker or the animal. Rev Rul 76-486, 1976 Cum Bull 192. No deductions are allowable for distributions under IRC §§651 and 661. See Rev Rul 76-486, 1976 Cum Bull 192.

© The Regents of the University of California

§6.30 2. No Charitable Deduction

A companion animal trust that provides for companion animals for life, with the remainder going to a qualified charity, is not eligible for the estate tax charitable deduction. See IRC §2055(e)(2)(A). To be eligible for the deduction, a companion animal trust with a charitable remainder interest must satisfy the requirements for a charitable remainder annuity trust or unitrust under IRC §664(d)(1)-(2). If a companion animal trust has the flexibility to provide full support for companion animals for life, even if the property remaining in the companion animal trust when the trust ends will go to a qualified charity, under current law no charitable deduction will be allowed.

AUTHOR'S ADVICE: It is very important to explain this issue to the client and to include a provision in the estate planning document stating that the client understands and accepts this result.

© The Regents of the University of California

§6.31 3. Form: Remainder Gift Does Not Qualify for Charitable Deduction

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.31-1 Remainder gift does not qualify for charitable deduction

The settlor acknowledges that the interest in this trust given to the settlor's companion animals and any remainder gift to the charitable organization(s) will not qualify as a charitable remainder trust under current law, and will therefore preclude a charitable deduction for estate tax purposes. However, as the settlor's primary intent is to ensure the proper care of the companion animals, the settlor has chosen to forego the benefit of the charitable deduction.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.32 V. CHECKLIST FOR CLIENT INTERVIEW

§6.32 V. CHECKLIST FOR CLIENT INTERVIEW

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

- Discuss extra cost of drafting companion animal provisions with client.
- Does client want a trust for companion animals or to make an outright gift or to provide in some other way for companion animals?
- List current companion animals.
- Name, age, birth date if known, breed, sex, and physical description of each companion animal.
- Consider asking client to provide picture of each companion animal, and microchip and/or tattoo information.
- Name of current veterinarian, address, telephone number.
- If a companion animal trust will be used:
- Will the trustee of the settlor's living trust also serve as trustee for the companion animal trust or should a different trustee be appointed? If a different trustee, have client identify preferred trustees for the companion animal trust, and provide a list of full names and contact information (address, telephone, e-mail).
- Will the living trust include provisions for the companion animals during the settlor's lifetime if the settlor becomes unable to care for the companion animals? If not, a companion animal trust that is funded on the death of the settlor can provide only for companion animals that survive the settlor.
- Have client identify possible caretakers for companion animals, and provide a list of full names and contact information (address, telephone, e-mail).
- Discuss whether client wishes to vary the default provisions of Prob C §15212(e) to ensure that even if the companion animal trust is worth $40,000 or less, the trustee will segregate trust assets, maintain appropriate trust records, and be entitled to reasonable fees. See §6.4A.
- The client may wish to provide detailed care and feeding instructions for specific companion animals. The instructions could be included in the body of the companion animal trust, but, because these instructions are likely to change over time, the most cost-effective way to handle this is to have the client prepare separate written instructions to keep with his or her estate planning documents.
- Consider need for certificate of independent review for donative transfers to persons identified as "disqualified persons" under Prob C §§21350-21351. See California Trust and Probate Litigation, chap 6A (Cal CEB 1999); Drafting California Revocable Trusts §§5.14-5.15, 22.12-22.13 (4th ed Cal CEB 2003).

© The Regents of the University of California

§6.33 VI. SAMPLE TRUST PROVISIONS

The sample trust provisions for the single settlor trust in §6.34 and the married settlors trust in §6.35 follow the format of the respective trusts in Drafting California Revocable Trusts, Apps A and C (4th ed Cal CEB 2003). Thus, *e.g.,* Division II in §6.34 starts with paragraph E.

For execution of trust, signatures, and notary acknowledgment, see Revocable Trusts, Apps A and C.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/6 Estate Planning for Companion Animals/Pets/§6.34 A. Form: Sample Provisions for Single Settlor's Trust, With Provisions for Care of Companion Animals

§6.34 A. Form: Sample Provisions for Single Settlor's Trust, With Provisions for Care of Companion Animals

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.34-1 Sample provisions for single settlor's trust, with provisions for care of companion animals

The _ _[*name of trust*]_ _ Trust

I, _ _[*name of settlor*]_ _, sometimes hereafter called "settlor," residing in _ _[*name of county*]_ _, California, hereby create the _ _[*Name of Trust*]_ _ Trust, declaring:

DIVISION I
CREATION OF TRUST

DIVISION II
PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

[*For items A-D, see Revocable Trusts, App C, Division II*]

E. *Companion Animal Information*.

1. *Current Companion Animals*. I currently have the following companion animals: _ _[*List companion animal names, sex, breed and/or physical descriptions and birth dates or approximate ages.*]_ _

2. *Companion Animals Entitled to Benefits*. The term "companion animal" as used in this document refers to all companion animals of the settlor at the relevant time that are then dependent on the settlor for care and support.

DIVISION III
DISTRIBUTIONS DURING SETTLOR'S LIFETIME

A. *Distributions to Settlor During Lifetime.* During my lifetime, the trustee shall pay to or apply for my benefit as much of the income and principal of this trust as I request, plus such additional sums as the trustee in its discretion determines are appropriate for my health, education, maintenance, and support in accordance with my accustomed standard of living.

B. *Distributions to Companion Animals During Settlor's Incapacity.* During any period when I am incompetent to make requests, the trustee will distribute single sums or periodic payments out of the trust estate to support my then living companion animals in the same manner and in accordance with the provisions set forth in the Companion Animal Trust (see Division V, paragraph J) in this document (adjusted if necessary by circumstances).

DIVISION IV
DISTRIBUTION ON DEATH

A. *Distribution on Death*. On my death, the trustee will distribute the remaining trust property in accordance with the provisions in paragraph B. of this Division.

B. _ _[*Specify. In plan of distribution, describe dollar amount (see §6.21) or percentage or share of the trust estate (see §6.22) to be distributed to the trustee of the Companion Animal Trust.*]_ _

DIVISION V
ADDITIONAL DISTRIBUTION PROVISIONS

[*For items A-I, see Revocable Trusts, App C, Division V*]

J. *Companion Animal Trust*. Any assets distributed to the trustee of the Companion Animal Trust will be held as one separate trust, known as the Companion Animal Trust, for the benefit of all of the settlor's surviving companion animals. The Companion Animal Trust will be administered as follows:

1. *Purpose*. The primary purpose of this trust is to ensure that any companion animal of the settlor that survives the settlor _ _[*or that is dependent for care on the settlor during a period when the settlor is incapacitated*]_ _ will receive proper care for as long as the companion animal lives.

2. *Trustee*. The trustee of the Companion Animal Trust will be _ _[*the same as the trustee then serving as the main trustee under this document/specify name of trustee*]_ _.

The trustee is encouraged to arrange for the _ _[*name and address of animal protection organization*]_ _, or its successor organization, to have access to the books and records of the Companion Animal Trust. If the trustee is or becomes unwilling or unable to continue to act as trustee of the Companion Animal Trust, the Board of Directors of _ _[*name of animal protection organization*]_ _, or its successor organization, will have the power to appoint a successor trustee.

3. *Administration*. The trustee must apply as much of the net income and principal of the trust as the trustee deems reasonably necessary to provide for the care of all of the settlor's companion animals in accordance with the terms set forth below. Any income not distributed should be accumulated and periodically added to principal, at least annually.

a. The trustee is responsible for ensuring that each of the settlor's then living companion animals has a caretaker and a suitable home.

b. The trustee may serve as caretaker or must arrange for one or more independent caretakers to provide a home for the settlor's companion animals.

c. The trustee may remove and replace the caretaker in the trustee's discretion.

d. If the trustee places any of the companion animals with an independent caretaker, the trustee must visit each of those companion animals, or arrange for an independent person to do so, at least once every three months, to ensure that the companion animal is being properly cared for.

e. The trustee will pay trust funds, in the trustee's discretion, to the caretaker of each companion animal as needed to ensure that the needs of the companion animal for health, education, maintenance, and support are properly met. The trustee may make distributions as monthly allotments to the caretaker, to reimburse the caretaker for out-of-pocket expenses related to the care of the companion animal, as compensation for taking care of the companion animal, and/or directly to third parties who provide products or services for the companion animal. A trustee who also acts as a caretaker may pay trust funds to himself or herself as caretaker for these purposes. Because the settlor's primary intent is to provide for each companion animal, the entire Companion Animal Trust estate may be expended for this purpose.

f. So long as the value of the Companion Animal Trust equals or exceeds $_ _[*amount, e.g., $5,000*]_ _ the trustee must segregate trust assets; maintain books and records for the trust in sufficient detail to permit the preparation of the type of accounting required by Probate Code §16062, in the event an accounting is required by court order; and be entitled to reasonable fees for services rendered.

4. *Caretaker*. The caretaker is responsible for providing a proper home and loving care for the companion animal, and for working with the trustee to ensure that the financial needs of the companion animal are met.

5. *Veterinarian*. _ _[*Name of veterinarian, address, telephone number*]_ _ is the settlor's current veterinarian. The caretaker may remove and replace the veterinarian in the caretaker's discretion.

6. *Death of Companion Animal*. On the death of each of the settlor's companion animals, the trustee will pay any outstanding veterinarian bills and for the proper disposition of the companion animal's remains.

7. *Termination of Trust*. On the death of the last to die of the settlor's companion animals, and after satisfaction of paragraph 6 above, the Companion Animal Trust terminates and any remaining trust estate will be distributed in accordance with paragraph 8, below.

8. *Final Disposition of Companion Animal Trust Estate*. On the termination of the Companion Animal Trust the remaining trust estate, if any, will be distributed as follows:

a. _ _[*Specify.*]_ _

b. *Acknowledgement of Taxation*. The settlor acknowledges that the interest in this trust given to the settlor's companion animals and any remainder gift to the charitable organization(s) will not qualify as a charitable remainder trust under current law, and will therefore preclude a charitable deduction for estate tax purposes. However, as the settlor's primary intent is to ensure the proper care of the companion animals, the

settlor has chosen to forego the benefit of the charitable deduction.

DIVISION VI
DEBTS

DIVISION VII
OFFICE OF TRUSTEE

DIVISION VIII
TRUSTEE POWERS

DIVISION IX
TRUSTEE DUTIES, LIMITATIONS ON DUTIES, EXCULPATION

DIVISION X
RULES OF CONSTRUCTION

DIVISION XI
MISCELLANEOUS

DIVISION XII
REVOCATION, AMENDMENT, AND
EXERCISE OF APPOINTMENT POWERS

Comment: It is important to add the provision in Division V, paragraph J.8(b) if a remainder interest might go to charity.

For alternative and additional optional form language, see §§6.12 (trustee provision), 6.13 (appointment of caretaker), 6.16 (living arrangements), 6.22 (distribution of residue to companion animal trust), 6.28 (distribution of residue to charity).

© The Regents of the University of California

§6.35 B. Form: Sample Provisions for Married Couple's Trust, Revised to Provide for Care of Companion Animals

To download **Word** version, right click and choose *Save Target As*

To download **WordPerfect** version, right click and choose *Save Target As*

6.35-1 Sample provisions for married couple's trust, revised to provide for care of companion animals

OPENING DECLARATION

The _ _[*name of trust*]**_ _ Trust**

We, _ _[*name of settlor*]**_ _ and _ _**[*name of settlor*]**_ _, sometimes hereafter called "settlors," residing in _ _**[*name of county*]**_ _, California, hereby create the _ _**[*name of trust*]**_ _ Trust, declaring:**

DIVISION I
CREATION OF TRUST

DIVISION II
PURPOSES, TRUSTEES, AND FAMILY DECLARATIONS

[*For items A-D, see Revocable Trusts, App A, Division II*]

E. *Companion Animal Information*.

1. *Current Companion Animals*. We currently have the following companion animals: _ _[*List companion animal names, sex, breed and/or physical descriptions and birth dates or approximate ages.*]**_ _**

2. *Companion Animals Entitled to Benefits*. The term "companion animal" as used in this document shall refer to all companion animals of either settlor at the relevant time that were dependent on either settlor for care and support.

DIVISION III
DISTRIBUTIONS WHILE BOTH SETTLORS ARE LIVING

A. *Distributions of Community Property*. While we are both living, the trustee shall pay to us, or apply for our benefit, as much of the community property income and principal of this trust as either of us requests plus such additional sums as the trustee in its discretion determines are appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living. All distributions of community property income or principal shall be paid to us or applied for our benefit as community property.

B. *Distributions of Community Property to Companion Animals During Settlors' Incapacity.* During any period in which neither settlor is able to make requests, the trustee shall distribute single sums or periodic payments out of the trust estate to support all of either of the settlors' then living companion animals in the same manner and in accordance with the same provisions as set forth in the Companion Animal Trust (see Division VIII, paragraph _ _) in this document (adjusted if necessary by circumstances).

C. *Distributions of Separate Property*. While we are both living, trust property that is the separate property of one of us (the "owning settlor") shall be distributed or provided for use in kind as the owning settlor requests. If at any time an owning settlor is not competent to make requests, the trustee shall pay to us or apply for our benefit as much of the owning settlor's separate property trust property as the trustee deems appropriate for our health, education, maintenance, and support in accordance with our accustomed standard of living.

D. *Distributions of Separate Property to Companion Animals During Owning Settlor's Incapacity.* During any period in which the owning settlor is not competent to make requests, the trustee shall distribute single sums or periodic payments out of the trust estate to support all of _ _[*either of the/the owning*]**_ _ settlors' then living companion animals in the same manner and in accordance with the same provisions as set forth in the Companion Animal Trust (see Division VIII, paragraph _ _) in this document (adjusted if necessary by circumstances).**

DIVISION IV

DISTRIBUTION ON FIRST DEATH

DIVISION V
SURVIVOR'S TRUST

[*For item A, see Revocable Trusts, App A, Division IV*]

B. *Distributions During Survivor's Lifetime*. During the lifetime of the Surviving Settlor, the trustee shall pay to or apply for the benefit of the Surviving Settlor as much of the income and principal of the Survivor's Trust as the Surviving Settlor requests, plus such additional sums as the trustee, in the trustee's discretion, determines are appropriate for the Surviving Settlor's health, maintenance, support, or education.

C. *Distributions to Companion Animals During Surviving Settlor's Incapacity.* During any period in which the Surviving Settlor is not competent to make requests, the trustee shall distribute single sums or periodic payments out of the trust estate to support all of either of the settlor's then living companion animals in the same manner and in accordance with the same provisions as set forth in the Companion Animal Trust (see Division VIII, paragraph _ _) in this document (adjusted if necessary by circumstances).

D. *Distribution on Death—General Power of Appointment*. On the death of the Surviving Settlor, the trustee shall distribute the remaining trust property as the Surviving Settlor appoints in accordance with the provisions of this trust for exercising a power of appointment. This is a general power of appointment that may be exercised in favor of any desired appointee, including the Surviving Settlor's estate or the trustee of the Companion Animal Trust.

E. *Distribution if Power of Appointment Not Exercised*. If the Surviving Settlor's power of appointment is not effectively exercised regarding any property of the Survivor's Trust, the property not effectively appointed shall be distributed as follows: _ _[*Specify, e.g., the Companion Animal Trust could be funded with some or all of this property.*]**_ _**

F. *Marital Deduction Survivor's Trust*. If property included in the taxable estate of the Deceased Settlor passes to the Survivor's Trust by reason of the death of the Deceased Settlor, that property shall be held as a separate trust, called the Marital Deduction Survivor's Trust, to be administered and distributed in the same manner as the regular Survivor's Trust, except that during the lifetime of the Surviving Settlor, distributions may be made only to or for the benefit of the Surviving Settlor. It is contemplated but not required that the Surviving Settlor will eliminate the need for this separate trust after the death of the Deceased Settlor by directing that all assets of the Marital Deduction Survivor's Trust be distributed to the regular Survivor's Trust.

DIVISION VI
BYPASS TRUST

[*For items A-B, see Revocable Trusts, App A, Division VI*]

C. *Principal Invasions During Survivor's Lifetime*. If the income is insufficient, the trustee shall pay to or apply for the benefit of the Surviving Settlor at quarter-annual or more frequent intervals, as much of the principal of this Bypass Trust as the trustee in its discretion determines is appropriate for the Surviving Settlor's health, support, maintenance, and education. In exercising its discretion, the trustee is permitted, but not required, to take into account the Surviving Settlor's income and other resources readily available for these purposes.

D. *Distributions to Companion Animals During Surviving Settlor's Incapacity.* During any period in which the Surviving Settlor is not competent to make requests, the trustee shall distribute single sums or periodic payments out of the trust estate to support all of either of the settlor's then living companion animals in the same manner and in accordance with the same provisions as set forth in the Companion Animal Trust (see Division VIII, paragraph _ _) in this document (adjusted if necessary by circumstances).

E. *Distribution on Death—Special Power of Appointment*. On the death of the Surviving Settlor, the remaining assets of the Bypass Trust shall be distributed as the Surviving Settlor appoints, in accordance with the provisions of this document for exercising a power of appointment. The permitted appointees of this power are limited to descendants of a parent of either settlor, spouses and domestic partners (including former spouses and domestic partners) of such descendants, and organizations satisfying the definition of "charity" in the Division of this trust on Additional Distribution Provisions, trusts exclusively benefiting such persons and/or organizations, and the trustee of the Companion Animal Trust.

F. *Distribution if Power of Appointment Not Exercised*. If the Surviving Settlor's power of appointment is not effectively exercised as to any property of the Bypass Trust, the property not effectively appointed shall be distributed as follows: _ _[*Specify. Usually some of this property will be distributed to the trustee of the companion animal trust.*]**_ _**

DIVISION VII
QTIP TRUST

[*For items A-G, see Revocable Trusts, App A, Division VII*]

H. *Distribution on Death—Limited Power of Appointment*. On the death of the Surviving Settlor, the trustee shall distribute any remaining balance of the QTIP trust property to _ _[*specify class of beneficiaries, e.g., one or more of the settlors' issue and their spouses, including widows and widowers, or the trustee of the companion animal trust*]**_ _ on any terms and conditions, either outright or in trust, and in any proportion that the Surviving Settlor shall appoint in accordance with the provisions of this document for exercising a power of appointment.**

I. *Distribution if Power of Appointment Not Exercised*. Any trust property not effectively appointed by the Surviving Settlor under the preceding paragraph shall be distributed in accordance with the provisions for distribution of the Bypass Trust that would have applied on the death of the survivor of the settlors had the Surviving Settlor died first.

DIVISION VIII
ADDITIONAL DISTRIBUTION PROVISIONS

[*For items A-J, see Revocable Trusts, App A, Division VIII*]

K. *Companion Animal Trust*. Any assets distributed to the trustee of the Companion Animal Trust will be held as one separate trust, known as the Companion Animal Trust, for the benefit of all of the settlors' companion animals. The Companion Animal Trust will be administered as follows:

1. *Purpose*. The primary purpose of this trust is to ensure that any companion animal that was dependent for care on either of the settlors, and that neither settlor is now willing or able to care for, receives proper care for as long as the companion animal lives.

2. *Trustee*. The trustee of the Companion Animal Trust will be _ _[*name of trustee serving as the main trustee under this document/name of different trustee*]**_ _.**

The trustee is encouraged to arrange for the _ _[*name and address of animal protection organization*]**_ _, or its successor organization, to have access to the books and records of the Companion Animal Trust. If the trustee is or becomes unwilling or unable to continue to act as trustee of the Companion Animal Trust, the Board of Directors of _ _**[*name of animal protection organization*]**_ _, or its successor organization, will have the power to appoint a successor trustee.**

3. *Administration*. The trustee must apply as much of the net income and principal of the trust as the trustee deems reasonably necessary to provide for the care of all of the companion animals in accordance with the terms set forth below. Any income not distributed should be accumulated and periodically added to principal, at least annually.

a. The trustee is responsible for ensuring that each of the settlors' then living companion animals has a caretaker and a suitable home.

b. The trustee may serve as a caretaker or must arrange for one or more independent caretakers to provide a home for all of either of the settlors' companion animals.

c. The trustee may remove and replace the caretaker in the trustee's discretion.

d. If the trustee places any of the companion animals with an independent caretaker, the trustee must visit each of those companion animals, or arrange for an independent person to do so, at least once every three months, to ensure that the companion animal is being properly cared for.

e. The trustee will pay trust funds, in the trustee's discretion, to the caretaker of each companion animal as needed to ensure that the needs of the companion animal for health, education, maintenance, and support are properly met. The trustee may make distributions as monthly allotments to the caretaker, to reimburse the caretaker for out-of-pocket expenses related to the care of the companion animal, as compensation for taking care of the companion animal, and/or directly to third parties who provide products or services for the companion animal. A trustee who also acts as a caretaker may pay trust funds to himself or herself as caretaker for these purposes. Because the settlors' primary intent is to provide for each companion animal, the entire Companion Animal Trust estate may be expended for this purpose.

f. So long as the value of the Companion Animal Trust equals or exceeds $_ _[*amount, e.g., $5,000*]**_ _ the**

trustee must segregate trust assets; maintain books and records for the trust in sufficient detail to permit the preparation of the type of accounting required by Probate Code §16062, in the event an accounting is required by court order; and be entitled to reasonable fees for services rendered.

4. *Caretaker*. The caretaker is responsible for providing a proper home and loving care for the companion animal, and for working with the trustee to ensure that the financial needs of the companion animal are met.

5. *Veterinarian*. _ _[*Name of veterinarian, address, telephone number*]_ _ is the settlors' current veterinarian. The caretaker may remove and replace the veterinarian in the caretaker's discretion.

6. *Death of Companion Animal*. On the death of each companion animal, the trustee will pay any outstanding veterinarian bills and will pay for the proper disposition of the companion animal's remains.

7. *Termination of Trust*. On the death of the last to die of the companion animals, and after satisfaction of paragraph 6 above, the Companion Animal Trust terminates and any remaining trust estate will be distributed in accordance with paragraph 8, below.

8. *Final Disposition of Companion Animal Trust Estate*. On the termination of the Companion Animal Trust the remaining trust estate, if any, shall be distributed as follows:

a. _ _[*Specify.*]_ _

b. *Acknowledgment of Taxation*. The settlors acknowledge that the interest in this trust given to the settlors' companion animals and any remainder gift to the charitable organization(s) will not qualify as a charitable remainder trust under current law, and will therefore preclude a charitable deduction for estate tax purposes. However, as the settlors' primary intent is to ensure the proper care of the companion animals, the settlors have chosen to forego the benefit of the charitable deduction.

Comment:

Division VII, paragraph H.

> **CAUTION:** Income and principal of a QTIP trust can only be distributed to or used for the benefit of the surviving spouse. Thus, the trustee *cannot* be given discretion to distribute income or principal of the QTIP trust to companion animals. However, on the death of the surviving spouse, a limited power of appointment in the trust instrument may allow the trustee to distribute the residue of the QTIP trust to the trustee of the animal companion trust.

Division VIII, paragraph K.8(b). It is important to add this provision if a remainder interest might go to a charity.

For alternative and additional optional form language, see §6.12 (trustee provision), §6.13 (appointment of caretaker), §6.16 (living arrangements), §6.22 (distribution of residue to companion animal trust), §6.28 (distribution of residue to charity).

© The Regents of the University of California

7

Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation

Ralph E. Lerner

I. CHARITABLE TRANSFERS
- A. Statutory Incentive §7.1
- B. Governing Statutes §7.2

II. COMPLETE INTER VIVOS CHARITABLE TRANSFERS §7.3
- A. Status of Organization
  - 1. Public Versus Private Charities §7.4
    - a. Public or "50/30" Organizations §7.5
    - b. Private or "30/20" Organizations §7.6
  - 2. Verification of Eligible Donee Status §7.7
- B. Type of Property §7.8
  - 1. Capital Gain Property §7.9
  - 2. Ordinary Income Property
    - a. Definition §7.10
    - b. Works Created by Artist §7.11
    - c. Gift From Artist §7.12
  - 3. Taxidermy Property §7.12A
- C. General Percentage Limitation
  - 1. Ordinary Income Property Percentage Limitation §7.13
  - 2. Capital Gain Property Percentage Limitation §7.14
  - 3. Examples §7.15
  - 4. Related Use Rule
    - a. Definition §7.16
    - b. IRS Letter Rulings Construing Related Use Rule §7.17
- D. Chart: Qualified Organizations for Income Tax Deductions §7.18
- E. Appraisals: General Rules §7.19
  - 1. Qualified Appraisal §7.20
  - 2. Qualified Appraiser §7.21
  - 3. Appraisal Summary §7.22
  - 4. Appraisal Fee §7.23
- F. Procedure; Deed of Gift §7.24
- G. Checklist for Collectors §7.25

III. PARTIAL INTER VIVOS CHARITABLE TRANSFERS
- A. Fractional Gifts
  - 1. The Partial Interest Rule §7.26
  - 2. Valuation of Fractional Interest §7.27
- B. Fractional Gifts After August 17, 2006 §7.28
  - 1. Valuation Limitation §7.28A
  - 2. Timing Limitation §7.28B
  - 3. Use Limitation §7.28C
  - 4. Recapture of Deduction §7.28D
  - 5. Denial of Deduction §7.28E
  - 6. Estate and Gift Tax Treatment §7.28F
  - 7. Possible Planning §7.28G
  - 8. Factors to Consider When Deciding Whether to Make Fractional Gift §7.29
- C. Retained Life Estate: The Future Interest Rule §7.30
- D. Charitable Remainder Trust
  - 1. Art Held for Trust Term §7.31
  - 2. Art Sold Within First Year
    - a. Planning Opportunities §7.32

b. Illustrative IRS Letter Ruling §7.33
c. Related Use Rule Issue and Two Aggressive Planning Solutions §7.34
d. Trustee Issue: Grantor Trustee or Independent Trustee §7.35
3. Art Sold After First Year §7.35A
E. Private Operating Foundation §7.36
1. Income Test §7.37
2. Asset Test
a. Definition §7.38
b. IRS Rulings on Asset Test §7.39
3. Endowment Test §7.40
4. Support Test §7.41

IV. COMPLETE TESTAMENTARY CHARITABLE TRANSFERS §7.42

V. RETAINED COPYRIGHT INTEREST §7.43

VI. VALUATION §7.44
A. IRS Valuation Regulations §7.45
B. Determining Fair Market Value
1. IRS Practice in Determination of Value; IRC §7517 §7.46
2. IRS Advance Ruling Procedure §7.47
C. Litigating Fair Market Value §7.48
1. Relevant Market
a. Wholesale Market
(1) Relevant "Retail Market" Can Be Wholesale Market §7.49
(2) Relevant "Retail Market" Is Middleman Market; Donation of Bargain Property §7.50
b. Retail Market With Blockage Discount §7.51
c. Market Data Comparison Approach §7.52
d. Relevant Retail Market: Art Galleries or Auction Sales
(1) Relevant Retail Market Is Art Galleries §7.53
(2) Relevant Retail Market Is Auction Market §7.54
e. Collector's Market §7.55
f. Comparable Sales Prices §7.56
g. "Glamour" Premium §7.57
h. Authenticity Dispute Depresses Value §7.58
i. Valuation of Stolen Property §7.59
2. Estate Inclusion Value Consistent With Deduction Value §7.60
D. Trend in Valuation Cases §7.61
E. Basis for Purposes of Sale §7.61A

VII. FORMS
A. Form: Letter Requiring Information From Charity Before Contribution §7.62
B. Form: Deed of Gift of Entire Interest §7.63
C. Form: Deed of Gift of Entire Interest (Several Items; Specific Conditions) §7.64
D. Form: Deed of Gift of Fractional Interest §7.65
E. Form: Specific Gift of Work of Art §7.66
F. Form: Checklist for Qualified Appraisal §7.67

© The Regents of the University of California

I. CHARITABLE TRANSFERS

§7.1 A. Statutory Incentive

United States tax laws provide an incentive for individuals to contribute during their lifetime or on their death works of art to tax exempt organizations, *i.e.,* museums, universities, and other organizations that display and make use of works of art in furtherance of their tax-exempt purposes. IRC §170(c). Although reference is made to works of art in this chapter, it should be read to include all collectibles, *i.e.,* coins, stamps, antiques, jewelry, books, and other similar items of tangible personal property.

The lifetime transfer of a work of art to a charitable organization saves the individual donor income taxes because of the allowable income tax deduction; at the same time, the lifetime transfer relieves the donor of the expense and the worry connected with the maintenance of a valuable work of art.

EXAMPLE: A painting that cost the donor $1000 some years ago may have a fair market value of $10,000 today. A contribution today of the painting to charity that meets all the requirements discussed below produces an allowable charitable deduction of $10,000. For someone in the 35-percent federal income tax bracket, such a contribution saves $3500 in federal income taxes. Because the donor's out-of-pocket cost was only $1000, the taxpayer has made a $2500 tax-free economic profit and has enjoyed the use of the painting through its years of ownership.

Note that the income tax benefit is available only for contributions to United States tax-exempt organizations and not for contributions to foreign tax-exempt organizations unless, under narrow circumstances, a tax treaty specifically so provides. In that case a deduction is only available against source income from the foreign country. See IRS Publications 597 (Canada), 526 (Mexico and Israel).

A testamentary transfer of works of art to United States tax-exempt organizations saves estate taxes for the decedent's estate because the full fair market value of the works of art on the date of death is an allowable estate tax deduction. At the same time, the transfer relieves the estate of the problem of raising the cash necessary to pay the estate tax. Although such testamentary transfers are generally made to United States tax-exempt organizations, under certain limited circumstances the U.S. estate tax deduction is available for transfers to foreign governments or subdivisions if the items transferred are used exclusively for charitable purposes.

The National Endowment for the Arts and the National Endowment for the Humanities are constantly threatened by Congress to have their funding sharply reduced. Arts organizations, both large and small, must find a way to replace the grants they normally receive from the Endowments, or they will find themselves without the means to exist. By necessity, arts organizations will turn increasingly to private individuals for funding, hopefully finding a sympathetic ear consistent with the purposes of the organization. Fundraising from individuals is somewhat easier when the individual can be made aware of the income and estate tax benefits to be derived from the contribution.

© The Regents of the University of California

§7.2 B. Governing Statutes

The primary federal statutes regulating charitable giving are IRC §§170 (income tax deduction), 2055 (estate tax deduction), and 2522 (gift tax deduction).

With respect to state law, there is no California gift or inheritance tax. For income tax purposes, California law concerning charitable deductions generally parallels federal law. See Rev & T C §§17024.5, 17201.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.3 II. COMPLETE INTER VIVOS CHARITABLE TRANSFERS

§7.3 II. COMPLETE INTER VIVOS CHARITABLE TRANSFERS

Before making a lifetime donation of a work of art to a charitable organization, the donor must determine:

- The status of the charitable organization (see §§7.4-7.7; see also chart in §7.18);
- The type of property being contributed (see §§7.8-7.12);
- Whether the work satisfies the related use rule (see §§7.16-7.17); and
- Whether there is a qualified appraisal prepared by a qualified appraiser (see §§7.19-7.23).

© The Regents of the University of California

A. Status of Organization

§7.4 1. Public Versus Private Charities

Charitable organizations are characterized as either public charities or private foundations. Public charities generally receive part of their support from the general public. They include churches, schools, hospitals, museums, and other publicly supported organizations; private operating foundations; and certain organizations operated in connection with another public organization. They also include those private foundations that distribute all their receipts each year. Private foundations include all other organizations exempt under IRC §501(c)(3). IRC §§170(b)(1)(A)(i)-(viii), (b)(1)(B), (b)(1)(F)(i)-(iii), 509(a); Reg §§1.170A-9, 1.170A-9T.

© The Regents of the University of California

§7.5 a. Public or "50/30" Organizations

For income tax purposes, qualified organizations may be classified as IRC §170(b)(1)(A) organizations or IRC §170(b)(1)(B) organizations. For the former, a donor's annual contribution limits are 50 percent or 30 percent of the donor's contribution base (depending on whether the property contributed is long-term capital gain property; see §7.9). Thus, these organizations are sometimes referred to as "50/30" organizations. See §§7.13-7.14.

Possible donees listed in this category include:

- Corporations, trusts, community chests, funds, and foundations primarily supported by contributions from the general public and organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition or the prevention of cruelty to children or animals;
- A church or a convention or association of churches;
- Educational organizations with a regular faculty and enrolled students;
- Organizations providing medical care and medical research;
- University endowment funds;
- Organizations funded by the United States or a subdivision;
- IRC §509(a)(2) organizations (*i.e.*, organizations that receive at least one-third of their donations from public sources);
- IRC §509(a)(3) organizations (*i.e.*, organizations that support other tax-exempt organizations), sometimes called supporting organizations;
- A private *operating* foundation (see IRC §4942(j)(3) for definition of private operating foundation; see also §§7.36-7.41); and
- A private foundation that distributes 100 percent of its contributions (IRC §170(b)(1)(F)).

© The Regents of the University of California

§7.6 b. Private or "30/20" Organizations

Annual contribution limits under IRC §170(b)(1)(B) are 30 percent or 20 percent (depending on whether the property contributed is capital gain property; see §7.9) of the donor's contribution base. Sometimes, these organizations are referred to as "30/20" organizations. See §§7.13-7.14. Essentially these are all qualified organizations that are not IRC §170(b)(1)(A) 50/30 organizations. See §7.5. They include most private foundations.

© The Regents of the University of California

§7.7 2. Verification of Eligible Donee Status

It is important to verify the status of the charitable organization as either a public charity or a private foundation. Generally, a taxpayer will only receive a deduction of his or her cost for a contribution of an appreciated work of art made to a private foundation as opposed to the fair market value for a contribution made to a public charity.

Verification of a charity's status can be made by checking IRS Publication 78 (Cumulative List of Exempt Organizations) or by requesting the charitable organization to provide copies of letters from the IRS stating its status. It is, however, preferable to obtain copies of the organization's determination letter from the IRS stating the organization's status. Note that there is a difference between the organization's exemption ruling under IRC §501(c)(3) and its ruling as a "public" charity under IRC §509(a). For example, some organizations, notably churches, other religious organizations, and government entities, are not required to file for exempt status under IRC §501(c)(3) and may be qualified organizations even though not listed in IRS Publication 78. See Reg §1.508-1(a)(3)(i)-(iii).

NOTE: Generally, a donee that is eligible for income tax deduction purposes is also eligible for estate tax deduction purposes. IRC §§2055, 2522. However, there are some differences. For either tax purposes, the donee need not be organized in the United States or a possession. For income tax purposes, but not for estate tax purposes, gifts to cemetery associations are deductible. Also, for estate tax purposes, eligible donees are not broken down into categories as they are for income tax purposes.

© The Regents of the University of California

§7.8 B. Type of Property

The characterization of donated property as long-term capital gain property or ordinary income property is particularly important for lifetime charitable contributions. The proper characterization of contributed property as long-term capital gain property is crucial if the donor is to receive the full charitable deduction for appreciated tangible personal property.

Generally, if the four requirements for making a charitable donation are satisfied (see §7.3), a taxpayer will receive a deduction for the full fair market value for a donation of long-term capital gain property but will be limited to his or her cost for ordinary income property (including short-term capital gain).

The distinction between ordinary income and long-term capital gain, for tax rate purposes, is that ordinary income is taxed as high as 35 percent (for 2003-2008) and long-term capital gain from the sale of a collectible (IRC §1(h)(5)) is taxed at a maximum of 28 percent. IRC §1(h)-(i).

© The Regents of the University of California

§7.9 1. Capital Gain Property

In most cases, a work of art is "capital gain property" for the non-artist taxpayer. The term includes any property that, if sold at its fair market value at the time of the contribution, would have resulted in long-term capital gain. IRC §§170(b)(1)(C)(iv), 1221; Reg §§1.170A-8(d)(3), 1.170A-4(b)(2). Any appreciation in value, no matter how small, makes the property capital gain property.

The work of art is capital gain property if:

- It is a capital asset under IRC §1221;
- It has appreciated in value; and
- It has been held by the donor for more than one year for contributions made after January 1, 1988 (IRC §1222(3)).

See *Robert H. Orchard*, TC Memo 1975-31 (opera tapes held less than six months not capital gain property). See also *William Glen* (1982) 79 TC 208 (valuation of tape recordings of interviews with noted scientists); *Quintin U. Ford*, TC Memo 1983-556.

Taxpayers should note that IRC §1(h)(5) now clearly provides that losses from the sale of collectibles can be used to offset gains from the sale of collectibles. The term "collectibles gain" is defined in IRC §1(h)(5)(A) to mean:

> [G]ain… from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing… taxable income.

Outside the charitable giving context, a work of art received by the beneficiary of a testamentary disposition is capital gain property. For an heir, legatee, or devisee who receives a work of art, the basis of the property is determined under IRC §1014 at the fair market value at the decedent's death (or alternate valuation date, if applicable). Thus, the basis is not dependent on the creator's or collector's basis in the work and is not excluded from capital gain treatment under IRC §1221(a)(3)(C). See §7.11. A person acquiring property from a decedent meets the capital gain holding period even if the property is sold within one year of the decedent's death. IRC §1223(9).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/ 2. Ordinary Income Property/§7.10 a. Definition

2. Ordinary Income Property

§7.10 a. Definition

A work of art is ordinary income property (IRC §§170(e)(1)(A), 1221(a)(3)(C); Reg §§1.170A-8(d)(3), 1.170A-4(b)(1)-(2)) if:

- It was created by the donor;
- It was received by the donor as a gift from the creator;
- It is held in inventory by a dealer;
- It would produce short-term capital gain if sold, *i.e.,* it is owned for one year or less before being contributed; or
- It would produce a capital loss if sold.

© The Regents of the University of California

§7.11 b. Works Created by Artist

All works of art created by the artist are ordinary income property, since that property, by the definition contained in IRC §1221(a)(3), cannot be a capital asset. The artist may be surprised that contributions of his or her own work will not receive favored capital gain property deduction treatment. Classification as ordinary income property greatly reduces any available charitable deduction.

© The Regents of the University of California

§7.12 c. Gift From Artist

A gift of a work of art from the creator retains its character as ordinary income property in the hands of the donee. The term capital asset "does not include property held by a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands" of the taxpayer whose personal efforts created the property. IRC §1221(a)(3). For gifts, the basis of the property in the hands of the donee is determined by its basis in the hands of the donor. IRC §1015. Thus, the collector who receives artwork as a gift from an artist has the same basis in the property as does the artist. Because artwork is ordinary income property in the artist's hands, it cannot be a capital asset in the donee collector's hands. If the artwork is purchased by the collector, however, it is converted into capital gain property, which results in an increased charitable deduction because the collector can deduct the fair market value of the artwork, not just its basis, *i.e.,* its cost.

PRACTICE TIP: When advising a collector who is making a contribution, the attorney should find out how and when the collector acquired the property to determine if the property is ordinary income property.

© The Regents of the University of California

§7.12A 3. Taxidermy Property

For taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property or by a person who paid or incurred the cost of preparation, stuffing, or mounting, the amount of the claimed charitable contribution must be reduced by the amount of gain that would have been long-term capital gain if the property had been sold by the taxpayer at its fair market value. IRC §170(e)(1)(B)(iv). Fair market value is determined at the time the contribution is made. Thus, the amount that will be allowed as a deduction for a charitable contribution of taxidermy property is the lesser of the donor's basis in the property or the fair market value of the property.

If taxidermy property is contributed and a charitable contribution deduction is claimed by the person who prepared, stuffed, or mounted the property, or by any person who paid or incurred the cost of such preparation, stuffing, or mounting, only the cost of preparing, stuffing, or mounting the taxidermy property may be included in calculating the basis of the property. IRC §170(f)(15)(A).

This special rule for determining the donor's basis in taxidermy property is intended to include only the direct costs of preparing, stuffing, or mounting that are paid or incurred by the donor claiming the charitable contribution deduction. Indirect costs, such as transportation, equipment, or other costs related to hunting or killing the animal may not be included in the donor's basis, and are, therefore, not deductible. Joint Committee on Taxation Report JCX-38-06 (JCT Report), *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* as passed by the House on July 28, 2006, and as considered by the Senate on Aug. 3, 2006, 297 (Aug. 3, 2006), available at http://www.jct.gov/x-38-06.pdf.

Reducing the abuse of the lenient deduction rules for such charitable contributions was a primary motivation for amending the rules. According to the Humane Society of the United States, the charitable contribution deduction rules for taxidermy property were being exploited by trophy hunters; the rules allowed them to unfairly deduct the costs of their hunting excursions. The modified rules do not allow the donor to claim a deduction for such expenses and, consequently, also eliminate the deduction for value based on the rarity of the animal.

The term taxidermy property means any work of art that (IRC §170(f)(15)(B)):

- Is the reproduction or preservation of an animal, in whole or in part;
- Is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal; and
- Contains a part of the body of the dead animal.

© The Regents of the University of California

C. General Percentage Limitation

§7.13 1. Ordinary Income Property Percentage Limitation

For contributions of cash and *ordinary income* property to a *public* charity, the charitable deduction is limited to 50 percent of the taxpayer's contribution base. IRC §170(b)(1)(A). The term "contribution base" means adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC §172. IRC §170(b)(1)(G).

For contributions to a *private* foundation, the limit is the lesser of (IRC §170(b)(1)(B)):

- 30 percent of the taxpayer's contribution base; or
- The excess of 50 percent of the taxpayer's contribution base over the amount of charitable contributions allowable to public charities, determined without regard to the 30-percent limitation.

The amount of the charitable deduction for a contribution of ordinary income property is limited to the basis of the property in the hands of the donor (within the applicable general percentage limitation discussed in the preceding paragraph). That result is reached because the amount of the charitable deduction is determined by subtracting from the fair market value of the property the amount of gain that would not have been long-term capital gain (determined without regard to IRC §1221(b)(3)) if the property contributed had been sold by the taxpayer at its fair market value. IRC §170(e)(1)(A); Reg §1.170A-4(a)(1). See *Maniscalco v Commissioner* (6th Cir 1980) 632 F2d 6.

Any excess amount over the 50-percent or 30-percent limitations for a contribution of ordinary income property to either a *public* charity or *private* foundation may be carried forward for five years, retaining its character as ordinary income property. IRC §170(d)(1)(A), (b)(1)(B) (last sentence). After the donor dies, there is no carryover of any remaining contribution deduction to his or her estate, but if the property is community property, one half of the remaining contribution deduction is available to the surviving spouse.

© The Regents of the University of California

§7.14 2. Capital Gain Property Percentage Limitation

A contribution to a *public* charity of a work of art that is long-term capital gain property and that meets the related use rule (see §§7.16-7.17) is allowable as a charitable deduction to the extent of the full fair market value of the property on the date of the contribution, but not in excess of 30 percent of the taxpayer's contribution base. IRC §170(b)(1)(C)(i). Any amount that exceeds the 30-percent limitation may be carried forward for five years, retaining its character as capital gain property. IRC §170(d)(1)(A), (b)(1)(C)(ii). If the contributed work of art satisfies the related use rule, the taxpayer may elect to increase the 30-percent limitation to 50 percent of his or her contribution base. If that election is made, however, the amount of the deduction must be reduced by 100 percent of the appreciation in value of the work of art (IRC §170(b)(1)(C)(iii), (e)(1)); in other words, the deduction will be limited to the donor's cost.

A contribution to a *private* foundation of a work of art that is capital gain property is allowable as a charitable deduction to the extent of the fair market value of the work of art on the date of the contribution *reduced* (regardless of what use the charity makes of the work of art) by 100 percent of the appreciation in value. After the reduction, the deduction is limited to the *lesser* of (1) 20 percent of the taxpayer's contribution base or (2) the excess of 30 percent of the taxpayer's contribution base over the amount of charitable contributions allowable to public charities, determined without regard to the 30-percent limitation. IRC §170(b)(1)(C)(i), (e)(1)(B)(ii).

The amount of the charitable deduction that exceeds the applicable percentage limitation may be carried forward for five years for contributions made in taxable years ending after July 18, 1984. IRC §170(b)(1)(D)(ii). After the donor dies, there is no carryover of any remaining contribution deduction to his or her estate, but if the property is community property, one half of the remaining contribution deduction is available to the surviving spouse.

PRACTICE TIP: The percentage limitations on lifetime gifts to private foundations and the loss of 100 percent of any appreciation in value as a deduction make use of a private foundation to hold a work of art impractical, unless the foundation can qualify as a "private operating foundation." IRC §4942(j)(3). Contributions to a private operating foundation are treated like contributions to a public charity. See Reg §53.4942(b)-1.

© The Regents of the University of California

§7.15 3. Examples

The following examples illustrate the application of the percentage limitations to inter vivos charitable transfers.

EXAMPLE 1: Ms. Collector received a painting as a gift from a little-known artist. The painting had a basis at the time of the gift of $100, representing the artist's cost for paint, canvas, and brushes. Twenty years later, after the artist had become famous, the painting had a fair market value of $10,000. If Ms. Collector now contributes the painting to an art museum, her maximum charitable deduction is $100, because the property contributed is ordinary income property. The entire $9,900 of appreciation in value is lost as a charitable deduction.

EXAMPLE 2: Mr. Collector has a contribution base of $100,000. He contributes capital gain property with a fair market value of $50,000, in which he has a basis of $10,000, to a public charity. If the contribution satisfies the related use rule and there is a qualified appraisal by a qualified appraiser, Mr. Collector is allowed a deduction of $30,000 (30 percent of $100,000) and a carryover of $20,000. If the contribution does not satisfy the related use rule, Mr. Collector is allowed a deduction of $10,000 ($50,000 − $40,000 appreciation = $10,000), and there is no carryover. If there is not a qualified appraisal by a qualified appraiser, Mr. Collector would not be allowed any deduction.

EXAMPLE 3: Mr. Collector has a contribution base of $100,000. He contributes capital gain property with a fair market value of $60,000 in which he has a basis of $40,000 to a public charity. If the contribution satisfies the related use rule and there is a qualified appraisal by a qualified appraiser, Mr. Collector is allowed a deduction of $30,000 (30 percent of $100,000) and a carryover of $30,000. If the contribution does not satisfy the related use rule or the election to increase the deduction is made, Mr. Collector is allowed a deduction of $40,000 ($60,000 − $20,000 appreciation = $40,000), and there is no carryover.

© The Regents of the University of California

4. Related Use Rule

§7.16 a. Definition

The related use rule applies to capital gain property that is "tangible personal property" contributed to a *public* charity. The term "tangible personal property" includes paintings and art objects not produced by the donor. The related use rule requires that the use of the tangible personal property by the donee organization be related to the purpose or the function that is the basis for the donee's exemption under IRC §501. If the use of the work of art by the donee organization is unrelated to the purpose or the function constituting the basis for the donee's exemption, the amount of the charitable deduction must be reduced by 100 percent of the appreciation in value of the work of art (effective for contributions made on or after January 1, 1987). IRC §170(e)(1)(B)(i); Reg §1.170A-4(b)(3). In that instance, after the 100-percent appreciation reduction, the remainder may be deducted up to 50 percent of the taxpayer's contribution base. IRC §170(b)(1)(A), (c)(1).

The regulations (Reg §1.170A-4(b)(3)(i)-(ii)) provide that a taxpayer may treat a contribution of a work of art as meeting the related use rule if:

- The taxpayer establishes that the work of art is not in fact put to an unrelated use by the donee; or
- At the time of contribution, it is reasonable to anticipate that the work of art will not be put to an unrelated use by the donee organization.

If a collector donates a work of art to a museum and the work of art is of a general type normally retained by museums for museum purposes, it is reasonable for the donor to anticipate, unless he or she has actual knowledge to the contrary, that the work of art will not be put to an unrelated use by the donee, whether or not the work of art is later sold or exchanged by the donee. On the other hand, if an item is donated for the purpose of sale at an art auction to be run by the charity, that is an unrelated use, and 100 percent of the appreciation in value is lost as a charitable deduction.

EXAMPLE 1: A painting contributed to an art museum that is a public charity and that can and, in fact, does from time to time display the painting prominently and publicly satisfies the related use rule. The contribution is deductible to the extent of the fair market value of the property within the 30-percent limitation.

EXAMPLE 2: If the same painting is contributed to the Red Cross, which is a public charity and which from the outset intends to sell and in fact promptly does sell the painting, the deduction must be reduced by 100 percent of the appreciation in value, with the balance deductible within the 50-percent limitation. See, *e.g., Larry M. Isbell,* TC Memo 1982-534 (contribution of Han dynasty jar to PBS television station unrelated to its exemption).

The regulations also indicate that the related use rule is met even if the donee sells or otherwise disposes of only an "insubstantial" portion of a collection of works of art. Reg §1.170A-4(b)(3)(i).

PRACTICE TIP: It is important to make sure that a proper paper trail shows that it was reasonable for the taxpayer to anticipate that the property would not be put to an unrelated use by the donee.

The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) added IRC §170(e)(7)(A). It provides that if a charitable organization receives appreciated tangible personal property as a charitable contribution and disposes of the property within 3 years of receiving it, the donor may not derive any tax benefit beyond a deduction in the amount of the property's basis. However, this rule will not apply if the donee provides a certification that the property was put to a use related to the donee's exempt purpose or states how the property was intended to be used by the donee at the time of the donation and certifies that such use has become impossible. IRC §170(e)(7)(B).

WARNING: This provision makes it clear that the IRS will be giving increased scrutiny to the "related use rule."

© The Regents of the University of California

§7.17 b. IRS Letter Rulings Construing Related Use Rule

To date there have been few litigated cases on the subject of related use. However, a number of private letter rulings in this area do shed some light on what the IRS considers a related use.

In the following cases, the IRS ruled that the related use rule was satisfied:

- When lithographs were displayed in a camp and center devoted to handicapped and retarded children because the lithographs were used in connection with an art appreciation program. IRS Letter Ruling 7751044. IRS Letter Rulings 7911109 and 7934082 reached similar results in dealing with the exhibition of works of art.
- When a donor gave his collection of porcelain art objects to a public charity operating a retirement center, since the display of the art was related to the charity's exempt purpose of creating a living environment for its residents. IRS Letter Ruling 8143029.
- When a donor gave his stamp collection to a college, because it would be exhibited and the college had, as part of its curriculum, the teaching of engraving skills. The donor included in the ruling request letters from the college, explaining in detail how it would use the collection. IRS Letter Ruling 8208059.

See also IRS Letter Rulings 8439005 (manuscripts to university: related use), 8333019 (art collection to museum: related use), 9833011 (paintings to Jewish Community Center: related use).

In the following cases, the IRS held that the related use rule was not satisfied:

- When a donor gave an antique car to a university, because the university did not offer a course in antique car restoration. IRS Letter Ruling 8009027.
- When a donor gave a horse to the American Cancer Society. *Philip G. Coleman,* TC Memo 1988-538.

See also *Raymond Dean Jennings*, TC Memo 1988-521 (paintings to cancer society, hospital, and college:); IRS Letter Rulings 8536022 (condominium to charity), 9452026 (violin to charitable remainder annuity trust).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.18 D. Chart: Qualified Organizations for Income Tax Deductions

§7.18 D. Chart: Qualified Organizations for Income Tax Deductions

	Public (50/30) Organizations	**Private (30/20) Organizations**
Governing statutes	IRC §170(b)(1)(A), (b)(1)(C).	IRC §§170(b)(1)(B), (b)(1)(D), 509(a).
Possible donees	Churches, schools, hospitals. Private operating foundation; IRC §§170(b)(1)(F), 4942(j); Reg §53.4942(b)-1. Private foundation distributing 100% of contributions; IRC §170(b)(1)(F). Supporting organizations; IRC §509(a)(3).	Most private foundations (other than private operating foundations and private foundations distributing 100% of contributions).
Income tax exemption of organization under IRC §501(c)	Yes. **Note:** Churches, other religious organizations and government entities need not file for exempt status and may be qualified organizations even though not listed in IRS Pub 78; Reg §1.508-1(a)(3)(i)-(iii).	Yes.
Allowable deduction	**Ordinary income property:** Fair market value *reduced* by any gain that would not have been long-term capital gain (determined without regard to IRC §1221(b)(3)) if the property contributed had been sold by taxpayer at its fair market value; IRC §170(e)(1)(A). **Capital gains property:** Same as above.	Same as for public organization.
Annual contribution limit (of individual donor; also called percentage limitation)	**Ordinary income property:** 50% of contribution base;* IRC §170(b)(1)(A).	**Ordinary income property:** The lesser of (IRC §170(b)(1)(B)): (a) 30% of contribution base; or (b) Excess of 50% of contribution base over amount of charitable contributions allowable to public charities without regard to 30% limitation.

	Capital gains property: 30% of contribution base (unless an election is made); IRC §170(b)(1)(C)(i).	**Capital gains property:** 2-step process (IRC §170(b)(1)(D)(i), (e)(1)(B)(ii)): (1) Reduction: Fair market value reduced by 100% of appreciation (*i.e.,* cost). (2) After reduction, deduction is limited to the lesser of: (a) 20% of contribution base; or (b) Excess of 30% of contribution base over amount of charitable contributions allowable to public charities, determined without regard to 30% limitation. **NOTE:** Loss of 100% of any appreciation and percentage limitations make use of private foundation impractical.
Carryover (of charitable deduction that exceeds applicable percentage limitation)	Yes; 5 years; IRC §170(b)(1)(D)(ii), (d)(1)(A).	Yes; 5 years; IRC §170(b)(1)(B) (last sentence), (b)(1)(D)(ii), (d)(1)(A). **Note:** Only for contributions made in taxable years ending after Oct. 16, 1984.
Related use rule	Yes, if capital gains property.	No.

*Contribution base means the taxpayer's adjusted gross income computed without regard to any net operating loss carryback to the taxable year under IRC §172. IRC §170(b)(1)(G).

© The Regents of the University of California

§7.19 E. Appraisals: General Rules

Internal Revenue Code §170(a)(1) expressly provides that a charitable contribution is deductible only if it is verified in the manner required by IRS regulations. In order to obtain the income tax deduction, a qualified appraisal prepared by a qualified appraiser must be attached to the income tax return. The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) revised the definitions of qualified appraiser and qualified appraisal, and the IRS has issued interim guidance as to the new appraisal rules introduced by the Pension Protection Act in Notice 2006-96, 2006-46 Int Rev Bull 902.

NOTE: Until regulations are effective under IRC §170(f)(11), an appraisal that meets the requirements of Notice 2006-96 is treated as a qualified appraisal for purposes of IRC §170(f)(11). See §§7.21-7.22. The IRS issued proposed regulations on August 7, 2008, dealing with reporting requirements for noncash charitable deductions. 73 Fed Reg 45908 (2008). The proposed regulations offer some guidance on qualified appraisals and qualified appraisers.

Regulations encompassing the charitable deduction substantiation requirements apply to any charitable contribution made after December 31, 1984, by an individual, closely held corporation, personal service corporation, partnership, or S corporation of an item of property (other than money or publicly traded securities) the claimed value of which exceeds $5000. Treas Reg §1.170A-13(c)(1). The $5000 amount applies to a single item of property or to the aggregate of similar items of property donated during one calendar year, such as a set or number of stamps, coins, lithographs, or books. Similar items of donated property are aggregated whether all the items are donated to one donee or the items are donated to two or more donees. Treas Reg §1.170A-13(c)(1)(i).

EXAMPLE: The substantiation requirements apply if the taxpayer claims a deduction in 1 year of $2000 for rare books given to College A, $2500 for rare books given to Museum B, and $900 for rare books given to Public Library C, a total of $5400, which is $400 over the approved limit.

Effective August 17, 2006, a qualified appraisal is also required for charitable contributions of a *single* item of clothing or a household item (such as furniture, furnishings, or electronics) with a value greater than $500. IRC §170(f)(16)(D)(ii). Paintings, antiques, other objects of art, jewelry, gems, or collections are not considered household items and fall under the general rules.

If the $5000 limit ($500 limit for a single household or clothing item) is reached, the taxpayer must meet the following substantiation requirements (Treas Reg §1.170A-13(c)(2)):

- Obtain a qualified appraisal from a qualified appraiser for the property contributed (see §§7.20-7.21);
- Attach a fully completed appraisal summary to the tax return on which the donor first claims the deduction for the contribution (see §7.22); and
- Maintain records containing certain specific information about the contribution.

WARNING: It is crucial to keep in mind that if a taxpayer does not conform strictly to the substantiation requirements, *no deduction* is allowed under IRC §170. See *Dewayne Bond* (1993) 100 TC 32; *A. Rick D'Arcangelo,* TC Memo 1994-572; *John L. Louderback,* TC Memo 1995-19.

If the $5000 claimed deduction amount is reached for a contribution of property, the appraisal regulations apply whether the donated property is capital gain or ordinary income property, whether the property has appreciated or depreciated in value since its acquisition by the donor, and whether the donee is a public charity, a private foundation, or some other donee eligible to receive contributions that may qualify for deduction under IRC §170. See Treas Reg §1.170A-13(c)(2).

© The Regents of the University of California

§7.20 1. Qualified Appraisal

The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) revised the definition of a "qualified appraisal" in IRC §170(f)(11)(E)(i) (applicable to appraisals prepared with respect to returns or submissions filed after August 17, 2006; see Pub L 109-280, §1219(e)(2)) to mean an appraisal of property that is:

(1) Treated as a qualified appraisal under the regulations or other guidance prescribed by the IRS; and

(2) Conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the IRS.

An appraisal is treated as having been conducted "in accordance with generally accepted appraisal standards" if the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (USPAP), as developed by the Appraisal Standards Board of the Appraisal Foundation. Notice 2006-96 §3.01, 2006-46 Int Rev Bull 902. For additional information on the USPAP, see http://www.appraisalfoundation.org.

The appraisal must contain the following information (Treas Reg §1.170A-13(c)(3)(i)-(ii)):

(1) A detailed description of the property;

(2) The physical condition of the property;

(3) The date or expected date of the contribution;

(4) The terms of any agreement or understanding entered into or expected to be entered into by or on behalf of the donor that relates to the use, sale, or other disposition of the property contributed;

(5) The name, address, and taxpayer identification number of the appraiser;

(6) A detailed description of the appraiser's background and qualifications;

(7) A statement that the appraisal was prepared for income tax purposes;

(8) The date on which the property was valued;

(9) The appraised fair market value of the property on the date (or expected date) of contribution;

(10) The method of valuation used to determine the fair market value;

(11) The specific basis for the valuation, such as any specific comparable sales transactions; and

(12) A description of the fee arrangement between the donor and the appraiser.

For a checklist for a qualified appraisal, see §7.67.

Obviously, the cost to the taxpayer of having a qualified appraisal prepared will be high because of the detailed information required. A separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. If the appraisal is for a group of similar items, the detailed information is required for each individual item other than items worth less than $100, for which a group description is allowed. Treas Reg §1.170A-13(c)(3)(iv)(A).

The qualified appraisal must be prepared, signed, and dated by a qualified appraiser not earlier than 60 days before the date of the contribution of the appraised property. Treas Reg §1.170A-13(c)(3)(i).

WARNING: The qualified appraisal must be received by the donor before the due date (including extensions) of the taxpayer's return (Treas Reg §1.170A-13(c)(3)(iv)(B)) or the entire charitable deduction will be lost. It is expected that the IRS will issue new regulations containing additional requirements. In the meantime, the existing requirements as set forth above, including Notice 2006-96, should be carefully complied with.

© The Regents of the University of California

§7.21 2. Qualified Appraiser

The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) revised the IRC §170(f)(11)(E)(ii)-(iii) definition of a "qualified appraiser" (applicable to appraisals prepared with respect to returns or submissions filed after August 17, 2006; see Pub L 109-280, §1219(e)(2)) to mean an individual who:

- Has earned an appraisal designation from a recognized professional appraiser organization, or has otherwise met minimum education and experience requirements set forth in regulations;
- Regularly performs appraisals for pay; and
- Meets other requirements that the IRS may prescribe in regulations or other guidance.

The IRS issued Notice 2006-96, 2006-46 Int Rev Bull 902, to implement the Pension Protection Act of 2006 and modify existing regulations. Under transitional terms, the notice provides that an appraiser will be treated as having earned an appraisal designation from a recognized professional appraiser organization if the designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed. Notice 2006-96 §3.03(1), 2006-46 Int Rev Bull 902. An appraiser will be considered to have demonstrated verifiable education and experience in valuing the type of property subject to the appraisal if the appraiser makes a declaration in the appraisal that "because of the appraiser's background, experience, education, and membership in professional associations, the appraiser is qualified to make appraisals of the type of property being valued." Notice 2006-96 §3.03(2).

For appraisals of real property, an appraiser will be treated as having met the minimum education and experience requirements if the appraiser is "licensed or certified" for the type of property being appraised in the state in which the appraised property is located (applicable to returns filed after October 19, 2006). Notice 2006-96 §3.03(3).

For property other than real property, an appraiser will be treated as having met the minimum education and experience requirements for returns filed on or before February 16, 2007, if the appraiser is qualified as a "qualified appraiser" under Treas Reg §1.170A-13(c)(5) (see definition below) to appraise the type of property in question. For later returns, the appraiser must (1) have successfully completed college or professional-level coursework that is relevant to the property being valued; (2) have had at least 2 years experience in the trade or business of buying, selling, or valuing the type of property being valued; and (3) fully describe his or her qualifications in the appraisal. Notice 2006-96 §3.03(3).

Thus, an individual cannot be a qualified appraiser with respect to any specific appraisal unless he or she demonstrates verifiable education and experience in valuing the property type being appraised. Further, the individual must not have been prohibited from practicing before the IRS at any time over the past 3-year period ending on the appraisal date.

WARNING: For appraisals prepared with respect to returns or submissions filed after August 17, 2006, it is imperative that the donor check the credentials of the appraiser to ensure that the appraiser is an expert in the item being appraised. In other words, an expert appraiser for Dutch 17th Century drawing will not be the appropriate appraiser for a work of contemporary art.

The term "qualified appraiser" means an individual who (Treas Reg §1.170A-13(c)(5)(i); Notice 2006-96, 2006-46 Int Rev Bull 902):

- Holds himself or herself out to the public as an appraiser who is an expert on the particular type of property being appraised;
- Understands that, if he or she makes a false or fraudulent overstatement of value, he or she may be subject to a civil penalty under IRC §6701 and, for appraisals for returns filed after February 16, 2007, under IRC §6695A for substantial or gross valuation misstatements (see appraiser declaration on IRS Form 8283, part 3); and
- Is completely independent of the donor.

To be independent of the donor, the qualified appraiser may not be the donor or the donee, a party to the

transaction in which the donor acquired the property (with one exception), a person employed by any of the foregoing, or a person related (within the meaning of IRC §267(b)) to any of the foregoing. Treas Reg §1.170A-13(c)(5)(iv). A party to the transaction can be a qualified appraiser, however, if the property is donated within 2 months of the date of acquisition and its appraised value does not exceed its acquisition price. Treas Reg §1.170A-13(c)(5)(iv)(B).

EXAMPLE: If a person acquires a painting from an art dealer and later donates the painting to a museum, the donor, the dealer who sold the painting, the museum, any person employed by the donor or the dealer or the museum, or any person related to any of the foregoing is not a qualified appraiser. The regulations are so broad that they appear to disqualify an auction house from being a qualified appraiser if the donor had purchased the property at auction from that auction house.

The regulations also disqualify anyone who regularly performs appraisals for a person who is not otherwise excluded from being a qualified appraiser and does not do a substantial number of appraisals for other persons (Treas Reg §1.170A-13(c)(5)(iv)(F)), *e.g.,* someone who performs appraisals for only one person. Also excluded as a qualified appraiser is any person who, if the donor had knowledge of the facts, would cause a reasonable person to expect that the appraiser would falsely overstate the value of the donated property. Treas Reg §1.170A-13(c)(5)(ii). For example, the donor and the appraiser make an agreement concerning the amount at which the property will be valued, and the donor knows that the amount exceeds the fair market value of the property.

WARNING: It is crucial that the appraiser selected be a "qualified appraiser." If the donor chooses unwisely and the appraiser is later found to be disqualified, the entire charitable deduction will be lost. To obtain the income tax deduction, a qualified appraisal prepared by a qualified appraiser must be attached to the income tax return when it is due. Treas Reg §1.170A-13(c)(2)(i)(b). However, because the question of whether the appraiser is qualified is not raised until the donor's tax return is audited, it will be impossible to cure the defect. See Treas Reg §1.170A-13(c)(3)(i)(A). Until new regulations are issued, the existing requirements as set forth above should be carefully complied with.

© The Regents of the University of California

§7.22 3. Appraisal Summary

Treasury Regulation §1.170A-13(c)(4) sets forth the information that is required on the appraisal summary that must be attached to the donor's income tax return. Completion of IRS Form 8283 (Noncash Charitable Contributions Appraisal Summary) will satisfy the appraisal summary requirements. A signed copy of the full appraisal must be attached to Form 8283 and a photograph must be made available to the IRS upon request. The donor also must provide the donee with a copy of the qualified appraisal. Treas Reg §1.170A-13(c)(4)(iv)(E).

NOTE: IRS Form 8283 must be signed and dated by both the appraiser and the donee charitable organization. The person signing on behalf of the donee must be an official authorized to sign the tax returns of the donee organization or a person designated by the donee organization to sign Form 8283.

If the taxpayer fails to attach the required appraisal summary to his or her tax return, the IRS can disallow the entire charitable deduction. Treasury Regulation §1.170A-13(c)(4)(iv)(H) permits a taxpayer to submit the appraisal summary within 90 days after the IRS requests it, however, and the IRS will not disallow the charitable deduction if the taxpayer's failure to attach the appraisal summary was a good faith omission.

© The Regents of the University of California

§7.23 4. Appraisal Fee

The fee paid to the appraiser may not be based on a percentage of the appraised value of the donated property. Treas Reg §1.170A-13(c)(6)(i). One narrow exception exists for fees paid to an association that regulates appraisers.

© The Regents of the University of California

§7.24 F. Procedure; Deed of Gift

A deed of gift should be used to make the gift, and formal acceptance by the charitable organization should be indicated in the deed, as set forth in form §§7.63-7.65. The deed of gift should be drafted in a manner that supports the taxpayer's compliance with the related use rule. It should also require the donee organization to sign IRS Form 8283.

Before the gift is made, there should be discussion and correspondence with the charitable organization to make sure that the related use rule is met. Correspondence with the charitable organization should establish the proof necessary to meet the related use rule. See sample letter in §7.62. The special election to increase the charitable deduction from 30 to 50 percent should be considered when the appreciation in the value of the property is relatively small. See §7.14. After the donor dies, there is no carryover of any remaining contribution deduction to his or her estate.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.25 G. Checklist for Collectors

§7.25 G. Checklist for Collectors

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

Before making the contribution, the donor should do the following:

- (1) Check the type of organization—public charity or private foundation;
- (2) Check the type of property—capital gain property or ordinary income property;
- (3) Check compliance with the related use rule;
- (4) Consider the special election to increase the deduction from 30 to 50 percent;
- (5) Prepare the deed of gift and have it signed by the donor and the donee organization;
- (6) Obtain a qualified appraisal by a qualified appraiser;
- (7) Make sure IRS Form 8283 is completed by the donee organization and the appraiser and that it is attached to the taxpayer's income tax return;
- (8) Obtain photographs in case the IRS should request them;
- (9) File the gift tax return if required—under the Taxpayer Relief Act of 1997 (Pub L 105-34, 111 Stat 788) a gift tax return is no longer required for the outright charitable transfer of the donor's entire interest in the property transferred to a charitable organization; and
- (10) Maintain the documentation for the income tax return required by the income tax regulations.

To *maximize* the charitable deduction, the donor should:

- (1) Make the contribution of appreciated tangible personal property to a public charity;
- (2) Be sure that the contribution satisfies the related use rule;
- (3) Make the contribution only with long-term capital gain property; and
- (4) Be sure that there is a qualified appraisal by a qualified appraiser of the contributed property.

© The Regents of the University of California

III. PARTIAL INTER VIVOS CHARITABLE TRANSFERS

A. Fractional Gifts

§7.26 1. The Partial Interest Rule

The collector who wants to give away a work of art and still enjoy its possession on a part-time basis should convey an undivided fractional interest of the collector's entire interest in the work of art to a charity. The transfer of an undivided fractional interest is *not* a transfer of a future interest and is *not* a transfer of a partial interest that would not be deductible under IRC §170(a)(3) or (f)(3)(A). IRC §170(f)(3)(B)(ii); Reg §§1.170A-5(a)(2), 1.170A-7(b)(1)(i). Therefore, an immediate charitable deduction is allowable for the value of the undivided fractional interest donated. However, the period of initial possession by the donee should not be deferred for more than 1 year, or the entire charitable deduction may be lost. Reg §1.170A-5(a)(2).

WARNING: Under new IRC §170(o), introduced by the Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780), effective for contributions made after August 17, 2006, fractional gifts may no longer be desirable. See discussion of IRC §170(o) in §§7.28-7.28G.

In *James L. Winokur* (1988) 90 TC 733, 740, acq 1989-2 Cum Bull 1, the court held that it is the *right* to entitlement or possession, not actual physical possession, that controls whether a purported present interest is to be regarded as a future interest:

> In order for an undivided interest to be treated as a present interest and not as a future interest, the donee simply must have the right to interrupt the donor's possession and the right to have physical possession of the property during each year following the donation, equivalent to its undivided interest in the property.

See also IRS Letter Rulings 8333019, 8535019.

EXAMPLE: Ms. Collector transfers an undivided one-fourth present interest in a painting to an art museum by deed of gift. She is entitled to possession of the painting for 9 months each year, and the museum is entitled to possession for 3 months each year. She can deduct one-fourth of the fair market value of the painting on the date of the gift, subject to the permissible maximum, as a charitable contribution.

© The Regents of the University of California

§7.27 2. Valuation of Fractional Interest

The IRS accepts as the allowable charitable deduction the undivided percentage of the fair market value given to the charitable organization. Presumably, the IRS position is based on Rev Rul 57-293, 1957-2 Cum Bull 153. (The part of Rev Rul 57-293 dealing with a gift of a future interest is no longer applicable because of IRC §170(f).) See also IRS Letter Rulings 200418002, 200223013, 9303007, 7934082, 7728046.

IRS Letter Ruling 9303007 should be reviewed by anyone contemplating a donation of a fractional interest in a work of art. The IRS ruled that the charitable deduction for the gift of an undivided fractional interest equals the product of (1) the fraction and (2) the fair market value (determined without regard to the existence of a certain loan agreement) of the entire work of art at the date of the gift of the fractional interest. Under a gift-loan agreement, the taxpayer in that private letter ruling imposed conditions requiring continuous display of the works of art and editorial control over publicity concerning the works of art. If those conditions were not complied with, the works of art would revert to the donor or his or her heirs. The IRS ruled that those conditions had no effect on the gift, because the chance that the work would revert to the estate of the donor was so remote as to be negligible.

When the collector dies, the value of the undivided fractional interest that was retained by the collector is includable in his or her estate. IRC §2033. If the retained interest is given to a person (other than charity) who does not own the other part, the taxpayer should have a fair chance of convincing the IRS to allow some discount for the fractional interest. In *Estate of Robert C. Scull,* TC Memo 1994-211, the Tax Court allowed a 5-percent discount for any uncertainties in acquiring decedent's 65-percent undivided interest in an art collection owned by the decedent and his former wife. In *Stone v U.S.* (ND Cal 2007) 2007-2 USTC ¶60,545, 100 AFTR 2d 5512, aff'd (9th Cir 2009) 2009-1 USTC ¶60,572, 103 AFTR2d 1379, the court allowed a 5-percent discount to an estate that owned an undivided 50-percent interest in 19 paintings that were left to family members. The case is significant because it is the first case to reflect on whether or not discounts based on lack of control, minority ownership, or fractional interests of works of art can lead to a discount for estate tax purposes, as it does for real estate, for bequests to noncharitable beneficiaries.

If the gift is made to the museum that already owns a partial interest in the painting, the estate tax charitable deduction is the percentage owned by the decedent multiplied by the full fair market value of the painting on the decedent's date of death.

PRACTICE TIP: Generally, before a museum will accept a fractional gift, it will want assurances that it will receive the balance of the undivided interest when the collector dies. The museum does not want to be left owning a fractional interest in a work of art with the donor's heir's fighting over the remaining fractional interest. Therefore, the donor should always discuss such a gift with the museum before making it.

When a fractional interest in a work of art is donated to a charitable organization, the organization usually requires the donor to promise to donate or devise the balance to the organization. IRS Letter Ruling 9303007 states that when one promises to transfer property in the future, the gift tax consequences of the promise are judged as of the time when it is possible to determine that the transfer must be made and that the transfer will be of a determinable amount. Therefore, the mere execution of a promised-gift agreement does not constitute a taxable gift because at the time of execution of the agreement, it is not possible to determine that the future transfer must be made by the donor. The promised gift could be satisfied by the donor's estate. Nor is it possible to know the amount of the future transfer until the property can be valued at the donor's death.

© The Regents of the University of California

§7.28 B. Fractional Gifts After August 17, 2006

The Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) added IRC §170(o) (effective for contributions made after August 17, 2006) to address perceived abuses in connection with fractional gifts. For discussion the treatment of fractional gifts under IRC §170(o), see §§7.28A (valuation), 7.28B (timing of the donation), 7.28C (use of gift the), 7.28D (recapture of the deduction), 7.28E (denial of the deduction), 7.28F (estate and gift tax treatment) and 7.28G (planning).

© The Regents of the University of California

§7.28A 1. Valuation Limitation

Under IRC §170(o), the collector's initial contribution of a fractional interest in a work of art is determined as under current law described in §7.27 (full fair market value times the fractional interest donated). For purposes of determining the deductible amount of each additional contribution in the same work of art, however, the fair market value of the donated item is limited under IRC §170(o)(2) to the *lesser* of (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution, or (2) the fair market value of the item at the time of the subsequent contribution.

EXAMPLE: The collector who gives away a 50-percent interest in a painting when it is worth $1 million would still be able to claim a $500,000 deduction. However, when the collector donates the remaining 50-percent interest 10 years later when the painting is worth $2 million, the collector's donation would be limited to 50 percent of the initial fair market value of $1 million, *i.e.,* $500,000, not 50 percent of the $2 million current value.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.28B 2. Timing Limitation

§7.28B 2. Timing Limitation

Under IRC §170(o)(3)(A)(i), the collector must complete the donation of his or her entire interest in the work of art before the earlier of:

- 10 years from the initial fractional contribution; or
- The donor's death.

If the donee charity is no longer in existence, the collector's remaining interest may be contributed to another IRC §170(c) organization.

© The Regents of the University of California

§7.28C 3. Use Limitation

The donee charity of a fractional interest in a work of art must (IRC §170(o)(3)(A)(ii)):

- Have substantial physical possession of the work of art during the donor allowed possession period (maximum of 10 years); and
- Use the work of art for an exempt use during such period, satisfying the related use rule (§§7.16-7.17).

If an art museum described in IRC §501(c)(3) that is the donee of a fractional interest in a painting includes the painting in an art exhibit sponsored by the museum, such use will generally be treated as satisfying the related-use requirement. Joint Committee on Taxation Report JCX-38-06 (JCT Report), *Technical Explanation of H.R. 4, The "Pension Protection Act of 2006,"* as passed by the House on July 28, 2006, and as considered by the Senate on Aug. 3, 2006, 307 (Aug. 3, 2006), available at http://www.jct.gov/x-38-06.pdf.

However, the JCT Report contains no example concerning the meaning of "substantial physical possession." For example, if a collector donates a 10-percent fractional interest in a painting to a museum and plans on donating the remaining 90 percent 10 years later, does the collector violate the substantial physical possession rule if the museum only has physical possession during the 10-year period for 10 percent of such period? The regulations will need to clarify this provision, although, if the museum has physical possession for a period of time equal to the donated percentage interest, that should be sufficient to satisfy this requirement.

© The Regents of the University of California

§7.28D 4. Recapture of Deduction

If the collector violates the 10-year timing limitation or the use limitation (the substantial possession or related-use requirement; see §7.28C), the collector's charitable income and gift tax deductions for *all* previous contributions of interests in the work of art are recaptured plus interest. IRC §170(o)(3)(A). In any case in which there is a recapture of a deduction, the statute also imposes an additional tax in an amount equal to 10 percent of the amount recaptured. IRC §170(o)(3)(B).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.28E 5. Denial of Deduction

§7.28E 5. Denial of Deduction

Under IRC §170(o)(1)(A), no income or gift tax deduction is allowed for a contribution of a fractional interest in a work of art unless immediately before the contribution all interests in the work of art are owned:

- By the collector; or
- By the collector and the donee organization.

The IRS is authorized to make exceptions to this rule if all persons who hold an interest in the work of art make proportional contributions of undivided interests in their respective shares of such art work to the donee organization.

EXAMPLE: If collector A owns an undivided 50-percent interest in a painting and his brother, collector B, owns the other undivided 50-percent interest in the painting, the IRS may, under regulations to be issued, provide that A may take a deduction for a charitable contribution of less than the entire interest held by A, if A and B make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee organization (*e.g.,* A contributes 25 percent of A's interest and B contributes 25 percent of B's interest).

© The Regents of the University of California

§7.28F 6. Estate and Gift Tax Treatment

Originally, the Pension Protection Act of 2006 (Pub L 109-280, 120 Stat 780) imposed similar limitations on fractional gifts as described in §§7.28A-7.28D for estate and gift tax purposes. See former IRC §§2055(g) (estate tax), 2522(e) (gift tax) (both applicable to contribution, bequests, and gifts made after August 17, 2006; see Pub L 109-280, §1218(d)). Like the income tax provision, former IRC §2055(g)(1) limited the estate tax charitable deduction to the *lesser* of (1) the fair market value at the time of the initial fractional contribution, or (2) the fair market value at the time of the subsequent contribution.

However, the Tax Technical Corrections Act of 2007 (Pub L 110-172, 121 Stat 1031) repealed those estate and gift tax special valuation limitations. The repeal was effective as if included in the Pension Protection Act of 2006. Pub L 110-172, §3(j), 121 Stat 1031. The net effect of this change is as if the valuation limitations (on the value at the time of the initial gift) never existed for estate and gift tax purposes. However, the other provisions affecting fractional gifts still apply, including the 10-year limitation to avoid the recapture of the income tax deduction under IRC §170(o)(3)(A)(i) (see §7.28B), so fractional gifting is still not advisable in most cases.

© The Regents of the University of California

§7.28G 7. Possible Planning

Now that the estate and gift tax treatment of fractional gifts has been clarified, IRC §170(o) may still be useful for a collector who owns a very valuable work of art and needs to spread the deduction for the initial value over a 12-year period (the year of donation plus a 5-year carryover for the first transfer, and the year of donation plus a 5-year carryover for the balance).

EXAMPLE: Assume a painting with a fair market value of $5,000,000 owned by an individual with an average yearly adjusted gross income (AGI) of $1,000,000. Because the maximum allowable charitable deduction is 30 percent of AGI, the collector's maximum deduction if the entire painting is donated is $1,800,000 ($300,000 × 6, *i.e.,* 30 percent of AGI and a 5-year carryover). If a one-half fractional interest in the painting is donated, the same $1,800,000 deduction over a 6-year period is allowable (50 percent of $5,000,000 is $2,500,000). In year seven, the individual can donate the remaining 50-percent interest in the painting and receive another $1,800,000 deduction spread over the following 6 years. Because the initial value of the painting is high, the individual would not be concerned with loss of the appreciation in value of the painting as a deduction.

WARNING: Internal Revenue Code §170(o) makes fractional gift planning for donations of works of art risky and generally no longer advisable. There have been serious proposals to make changes in this area that may in the future once again make fractional gift planning attractive.

© The Regents of the University of California

§7.29 8. Factors to Consider When Deciding Whether to Make Fractional Gift

When considering whether to make a fractional gift to a museum, if still deemed desirable after August 17, 2006, the donor must also be aware of the following questions that should be answered before making the donation:

(1) Who will pay for packing and transportation each time the painting is moved?

(2) Who will pay for insurance? Generally, the donor's insurance covers the painting when it is in the donor's possession, and the museum's insurance covers the painting when it is in the museum's possession. Insurance coverage during the packing and shipping period should be discussed.

(3) In the future operation of the museum, what will be done with the painting, how will it be exhibited, and will the museum consult with the donor?

(4) Does the museum have an endowment; if so, how are funds allocated to its operation? As the museum expands in size, its expenses will increase. Will there be a special curator for the painting, and how will the curator be selected and paid?

(5) What, if any, involvement will the donor have with respect to the exhibition of the painting at the museum?

(6) What will happen if the painting is damaged? Every time art is moved, there is always the risk of some damage. There should be some procedure involving condition reports, and perhaps some works of art should not be moved every year. For example, some Calder mobiles are susceptible to damage every time they are packed and rehung.

(7) If the painting is sold by the museum, must the proceeds be used to acquire another work of art?

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.30 C. Retained Life Estate: The Future Interest Rule

§7.30 C. Retained Life Estate: The Future Interest Rule

Under IRC §170(a)(3), it is not possible to reserve a life interest in a work of art and enjoy an immediate deduction for a present gift of the remainder to charity. Any income tax charitable deduction for a gift of a future interest in tangible personal property is postponed until there is no intervening interest in, right of possession of, or enjoyment of the property held by the donor, the donor's spouse, or any of the donor's brothers, sisters, ancestors, or lineal descendants. IRC §170(a)(3).

The term future interest includes situations in which a donor purports to give a work of art to a charitable organization, but has an understanding, arrangement, or agreement (whether written or oral) with the charitable organization that has the effect of reserving to or retaining in the donor a right to the use, possession, or enjoyment of the property. Reg §1.170A-5(a)(4). See also Reg §1.170A-13(b)(2)(ii)(G). In other words, there will be no present deduction allowed if a donor gives a work of art away with some sort of understanding or agreement through which the donor can borrow it back when he or she desires.

The contribution of a future interest does not necessarily mean that the charitable deduction is lost; it may only be postponed. Regulation §1.170A-5(a)(5) provides that the other provisions of IRC §170 are inapplicable to a contribution until the contribution is treated as made under IRC §170(a)(3). See IRS Letter Ruling 200223013.

EXAMPLE 1: In 1994, Mr. Collector transferred a painting to an art museum by deed of gift, but reserved to himself the right to the use, possession, and enjoyment of the painting during his lifetime. The value of the painting in 1994 was $90,000. Because the contribution consisted of a future interest, no deduction was allowed in 1994.

EXAMPLE 2: Assume the same facts as in Example 1, except that in 1996 Mr. Collector relinquished all his rights to the use, possession, and enjoyment of the painting and delivered it to the museum. If the value was $100,000 in 1996, Mr. Collector was entitled to a deduction of $100,000 in 1996, subject to the applicable percentage limitations.

WARNING: These examples, which are similar to those in the Regulations, can be a trap for the unwary. If a charitable transfer of a remainder interest in a work of art is made, the donor, as indicated above, does not receive a current charitable deduction. The danger is that the donor may incur a *current gift tax liability*. Under IRC §2522(c)(2) and Reg §25.2522(c)-3(c)(1), there is no gift tax charitable deduction for a transfer of the remainder interest in a work of art. Because a transfer of the remainder interest has taken place, however, there is a transfer subject to the gift tax. Reg §25.2511-1(e).

In Rev Rul 77-225, 1977-2 Cum Bull 73, a taxpayer claimed a charitable contribution deduction for a donation of a rare book collection. However, the taxpayer retained for his life the right of full access to the collection and the right to deny access to others. The IRS ruled that the taxpayer was not entitled to a charitable deduction, because the rights the taxpayer retained were equivalent to the retention of substantial rights to actual possession and enjoyment of the collection. Therefore, the gift was a donation of a future interest in tangible personal property, which is not deductible under IRC §170(a)(3). Although the ruling did not cover the gift tax question, the author believes that a taxable gift (of the remainder interest) was made. See Reg §25.2511-1(e).

NOTE: The future interest rule of IRC §170(a)(3) must be read in conjunction with the partial interest rule of IRC §170(f)(3)(A), which denies a deduction for a partial interest in property with certain exceptions not applicable to tangible personal property unless that interest is in the form of an annuity trust or unitrust. However, if there is no intention to avoid the application of IRC §170(f)(3)(A) by the conveyance, it appears that the rule does not apply. Reg §§1.170A-5(b), Examples 1-2, 1.170A-7.

EXAMPLE 3: In 1994, Mr. Collector transferred to his sons a life interest in a painting and on the same date transferred the remainder interest to charity with the intention of avoiding IRC §170(f)(3)(A). No deduction would be allowed to Mr. Collector for the remainder interest. If there had been no intention of avoiding IRC §170(f)(3)(A), §170(a)(3) still would have prevented any current deduction, and there would have been a gift tax on the present interest and

the remainder interest.

PRACTICE TIP: Because of the gift tax consequences, a remainder interest in a work of art should *never be transferred outright* to a charitable organization.

© The Regents of the University of California

D. Charitable Remainder Trust

§7.31 1. Art Held for Trust Term

A trust remainder interest passing to charity will be deductible for federal and California income, federal estate, and federal gift tax purposes only if it is made in the form of a charitable remainder annuity trust (IRC §664(d)(1)), a charitable remainder unitrust (or its alternative, a charitable remainder income-only unitrust) (IRC §664(d)(2)-(3)), or a pooled income fund (IRC §642(c)(5)). IRC §170(f)(2)(A). Thus, the planning opportunities for transfer of a work of art in trust are very limited (assuming the transfer does not run afoul of the future interest rule of IRC §170(a)(3)).

With one exception discussed below, IRC §170(f)(2)(A) made a transfer of non-income-producing property, such as a work of art, impractical because it cannot be put in the form of a guaranteed annuity, nor can it pay out a fixed percentage yearly of its fair market value. If from the outset it is clear that the property put in trust will never produce any income, the charitable deduction may be denied on the ground that a valid charitable remainder unitrust was not created, because the trust cannot make an annual payment. See Reg §1.664-3(a)(1). The Regulations make no mention of a remainder interest in non-income-producing property, such as a work of art. The only exceptions to the required unitrust form for a remainder interest in property given to a charity are contained in IRC §170(f)(3)(B)(i), which concerns a remainder interest in a personal residence or farm.

Further, the Regulations state that a remainder trust will not qualify under IRC §664 if its governing instrument contains a "provision which restricts the trustee from investing the trust assets in a manner which could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets." Reg §1.664-1(a)(3). See also Reg §1.170A-6(c)(3)(iii).

In Rev Rul 73-610, 1973-2 Cum Bull 213, the grantor of an irrevocable trust contributed a collection of antiques, in addition to income-producing assets, to a trust. The governing instrument of the trust provided that the grantor's spouse, who was the sole income beneficiary of the trust for her life, should have the use of the antique collection for her life. At her death, the antique collection and all the remaining assets in the trust were to be distributed to a charitable exempt organization. In all other respects the trust complied with the provisions of IRC §664 defining charitable remainder trusts. The IRS held that the retention of a life estate in the collection of antiques for the grantor's spouse restricted the trustee from investing all the trust assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets. Therefore, the trust did not qualify as a charitable remainder trust. See also Rev Rul 76-165, 1976-1 Cum Bull 279 (remainder interest in household furnishings bequeathed to surviving spouse for life and then to charitable organization did not qualify as deductible remainder interest in personal residence).

Therefore, a work of art that is required to be held for the trust term will probably disqualify the trust from being a charitable remainder unitrust or a charitable remainder annuity trust, and there will be no income tax charitable deduction.

© The Regents of the University of California

2. Art Sold Within First Year

§7.32 a. Planning Opportunities

One way to deal with Rev Rul 73-610, 1973-2 Cum Bull 213, and the prohibition on restricting the trustee's investment powers in Reg §1.664-1(a)(3) (see §7.31) is to specifically direct and empower the trustee to sell any non-income-producing property (*i.e.,* the work of art) at his or her discretion within the taxable year of its receipt by the trust. In such a case, the trustee is not "restricted" from investing the assets in a manner that could result in the annual realization of a reasonable amount of income or gain from the sale or disposition of trust assets.

Creating a charitable remainder unitrust or annuity trust to sell a work of art during the first year of the trust can be a useful planning technique. A work of art may have a very low cost and be worth a great deal of money. If a collector sells it, he or she will have to pay approximately one-third of the gain in federal and state income taxes, leaving only the balance to be invested to produce income. If the collector contributes the work of art to a charitable remainder trust instead, and the trust is the seller, the work of art can be sold tax-free. The one-third of the gain that would have gone in income taxes is preserved for future investment to produce more income for the collector. IRC §664(c). The collector can also claim a charitable deduction, although the amount of the deduction will probably be limited to the collector's cost that is allocable to the remainder interest in the work of art, because the contribution would not satisfy the related use rule.

PRACTICE TIP: The trust instrument should direct the sale in the year of receipt of any non-income-producing property to avoid any problem under IRC §170(a)(3) and (f)(2)(A).

The distributions out of the unitrust or annuity trust would carry out either taxable income or the capital gain realized by the trust. IRC §664(b).

For detailed discussion of the technical issues involved in creating or drafting a charitable remainder trust, see Drafting California Irrevocable Trusts, chap 18 (3d ed Cal CEB 1997).

A charitable remainder trust is not advisable for all clients. Clients must be aware that a charitable remainder trust is irrevocable and many of its terms may not be amended. Further, the administration of a charitable remainder trust can be burdensome. For example, despite being a tax-exempt vehicle, a California charitable remainder trust must file four tax returns—IRS Forms 5227 (Split Interest Trust Information Return) and 1041-A (Trust Accumulation of Charitable Amounts), and California Forms 541-A (Trust Accumulation of Charitable Amounts) and 541-B (Charitable Remainder and Pooled Income Trusts)—in addition to providing the beneficiary with IRS and California Schedules K-1. Furthermore, there is a prohibition against a provision that allows a distribution from the trust of more than 50 percent of the trust assets to the noncharitable beneficiary in any one year and a requirement for both annuity trusts and unitrusts that the value (determined under the IRC §7520 valuation tables) of the remainder interest going to the charitable organization must be at least 10 percent of the initial net fair market value of the property placed in the trust. IRC §664(d)(1)(D), (d)(2)(D).

© The Regents of the University of California

§7.33 b. Illustrative IRS Letter Ruling

In IRS Letter Ruling 9452026, the taxpayer created an inter vivos charitable remainder annuity trust that was to be funded with publicly traded securities and an appreciated musical instrument. The taxpayer was not in the business of dealing in musical instruments, nor did he depreciate the instrument. In other words, the instrument was a capital asset.

The IRS refused to rule on whether the trust qualified as a charitable remainder annuity trust. The ruling relied on Rev Proc 94-3, 1994-1 Cum Bull 447, that sets forth sample provisions for charitable remainder trusts, and stated that taxpayers relying on those provisions can be assured that the IRS will recognize the trust as meeting all the requirements to be a charitable remainder annuity trust.

The ruling concluded that, because the musical instrument is tangible personal property, IRC §170(a)(3) prevents any deduction for the remainder interest as long as the taxpayer retains an income interest in the musical instrument, referring to Reg §1.170A-5(b), Example 7. The ruling adds the following important statement:

> However, an income tax deduction would be allowed under section 170(a)(3) when the trustee sells the musical instrument. When the musical instrument is sold, Taxpayer no longer retains an intervening interest in the tangible personal property as contemplated under section 170(a)(3), that is, Taxpayer is only holding an income interest in the sale proceeds from the musical instrument. Accordingly, Taxpayer's intervening interest in the musical instrument is treated as terminated upon its sale.

But the sale by the trust would be considered as putting the musical instrument to an unrelated use for IRC §170(e)(1)(B)(i) purposes. Accordingly, the taxpayer's deduction would be reduced to the portion of the taxpayer's basis that is allocable to the remainder interest in the musical instrument.

Relying on *Daniel D. Palmer* (1974) 62 TC 684, aff'd (8th Cir 1975) 523 F2d 1308, acq 1978-1 Cum Bull 83, the IRS held that because there was no prearranged sale contract that legally bound the trust to sell the musical instrument, the taxpayer was not required to recognize any gain from the sale of the musical instrument.

© The Regents of the University of California

§7.34 c. Related Use Rule Issue and Two Aggressive Planning Solutions

Even if the trustee sells the work of art in the first year of the trust, the amount of the allowable charitable deduction available to the collector will be limited to the collector's cost that is allocable to the remainder interest in the work of art, because the transfer to the charitable remainder trust of a work of art that will be sold will not satisfy the related use rule of IRC §170(e)(1)(B)(i). Reg §1.170A-4(b)(3)(i) (definition of unrelated use). Regulation 1.170A-4(b)(3)(i) provides in part as follows:

> The use by a trust of tangible personal property contributed to it for the benefit of a charitable organization is an unrelated use if the use by the trust is one which would have been unrelated if made by the charitable organization.

Although the Regulation is not entirely clear, it causes a problem because the trust is making no use of the property contributed to it because, to qualify as a charitable remainder trust, it can not hold non-income-producing property.

An argument for the full charitable deduction (the key is to satisfy the "related use rule") can be made as follows: If the property was contributed directly to the remainder beneficiary charity (the organization that will receive the principal of the trust after the death of the noncharitable income beneficiary) and if it was reasonable to anticipate that the charity would not have put the property to an unrelated use, then the related use rule is satisfied and the charitable deduction should be allowable in full.

AUTHOR'S ADVICE: The problem is convincing the IRS that it was reasonable to anticipate such use. The argument may be enhanced if the contributed property is sold to the designated remainder beneficiary charity by the trustee. There is, however, no authority for that position, and without a specific IRS ruling, it is not recommended.

One commentator has suggested that if the charitable remainder beneficiary of the trust is a foundation described in IRC §170(b)(1)(A)(iv) whose function is to receive, hold, invest, and administer property and make expenditures for the benefit of a college or university, a sale by the trust of a work of art would satisfy the related use rule. Tidd, *Charitable Remainder Trusts: Funding and Investment Considerations*, 57 Taxes 577, 578 n7 (Sept. 1979). This appears to be a very aggressive position and, although the trust might qualify as a charitable remainder trust, in the author's opinion it is doubtful that the transfer would satisfy the related use rule.

© The Regents of the University of California

§7.35 d. Trustee Issue: Grantor Trustee or Independent Trustee

Subject to certain limitations, a grantor may serve as the trustee of his or her own charitable remainder trust. Reg §1.664-1(a)(4); IRS Letter Ruling 7730015. But see IRS Letter Ruling 9442017. If a work of art is to be used to fund the charitable remainder trust, however, it is preferable to use an independent trustee, even if the work of art will be sold in the first year of the trust. The House Ways and Means Committee stated the following in its report on unitrusts (H Rep No. 91-413 (pt 1), 91st Cong, 1st Sess (1969), reprinted in 1969 US Code Cong & Ad News 1706):

> It is contemplated that a charitable contribution deduction would be denied where assets which do not have an objective ascertainable market value, such as real estate or stock in a closely held corporation, are transferred in trust, unless an independent trustee is the sole party responsible for making the annual determination of value.

See also IRS Letter Ruling 9138024. Regulation §1.664-1(a)(7) provides that if a charitable remainder trust holds unmarketable assets and if the trustee is either (a) the grantor of the trust, (b) a noncharitable beneficiary, or (c) a related or subordinate party to the grantor or noncharitable beneficiary (within the meaning of IRC §672(c) and Regulations), then the trustee must use a current qualified appraisal from a qualified appraiser (as defined in Reg §1.170A-13(c)(3) and (c)(5), respectively) to value the unmarketable assets. A qualified appraisal from a qualified appraiser is not required if there is an independent trustee, except for the initial gift. See §§7.20-7.22.

That requirement should serve as a warning for a grantor who wishes to be a trustee of his or her charitable remainder trust when it is funded with a work of art.

© The Regents of the University of California

§7.35A 3. Art Sold After First Year

Although it is advisable to sell a work of art placed in a charitable remainder trust within the first year after creation of the trust, this may not always be possible. A charitable remainder unitrust is permitted to pay out only its income if that income is less than the stated pay-out percentage. IRC §664(d)(3)(A). Such a trust, called a net income method charitable remainder unitrust (NIMCRUT), may also have a "makeup" provision. Under such a provision, any amount by which the trust income falls short of the stated pay-out percentage is to be paid in subsequent years, to the extent that trust income exceeds the pay-out percentage in those years. IRC §664(d)(3)(B). A charitable remainder trust that starts as a NIMCRUT may later convert to a traditional charitable remainder trust. This type of unitrust, called a "flip unitrust," is ideal for a work of art if there is doubt about whether it will be sold in the first year of the trust.

A NIMCRUT may convert to a straight unitrust using the same pay-out percentage if the governing instrument of the trust meets the following requirements:

- The conversion from a net income unitrust to a straight unitrust must be triggered on a specific date or by a single event. The occurrence of that event (the triggering event) may not be discretionary with, or within the control of, the trustee or any other person. Reg §1.664-3(a)(1)(i)(c)(1). Permissible triggering events include marriage, divorce, death, or the birth of a child with respect to any individual. Reg §1.664-3(a)(1)(i)(d). The sale of an unmarketable asset, such as a work of art, real estate, or closely held or restricted stock, also is a permissible triggering event. The sale of marketable securities, however, is not a permissible triggering event because the timing of the sale is considered to be within the trustee's control or discretion. A beneficiary's or other person's attaining a specific age is a permissible triggering event. Reg §1.664-3(a)(1)(i)(e).
- The conversion must occur at the beginning of the tax year of the unitrust that immediately follows the tax year in which the triggering event occurs. Reg §1.664-3(a)(1)(i)(c)(2). For example, if the triggering event occurs on July 1, 2005, the conversion must occur on January 1, 2006.
- If the net income unitrust has a makeup provision, the unitrust's governing document must provide that any makeup amount not paid as of the conversion date is forfeited. Reg §1.664-3(a)(1)(i)(c)(3).

As discussed in §7.35, in order to avoid the requirement of a yearly qualified appraisal by a qualified appraiser, the grantor should not be the trustee—an independent trustee should be used.

© The Regents of the University of California

§7.36 E. Private Operating Foundation

A private operating foundation falls somewhere between a private foundation and a public charity. IRC §4942(j)(3). Private operating foundations are organizations that devote their assets or income to the active conduct of a charitable purpose, rather than making grants to other organizations. To qualify as a private operating foundation, the organization must satisfy the income test and either (1) the asset test, (2) the endowment test, or (3) the support test. Reg §53.4942(b)-1(a)(1). See §§7.37-7.41.

The major advantage of a private operating foundation is that from the donor's point of view, he or she is treated in the same manner for tax deduction purposes as if the contribution were made to a public charity. In other words, contributions of works of art to a private operating foundation can be deducted to the extent of their full fair market value as long as the other specific donation requirements are satisfied:

(1) The property has been owned for more than one year and was not a gift from the artist;

(2) The property satisfies the related use rule (that is, the use of the art is related to the exempt purpose of the donee-charity); and

(3) There is a qualified appraisal by a qualified appraiser.

If those requirements are met, the full fair market value of the works of art is available for a donation to a private operating foundation. IRC §170(b)(1)(A)(vii), (b)(1)(F)(i). Because the donor will be the creator of the private operating foundation and can act as its president, the donor is afforded a degree of control over the donated works and at the same time obtains a tax deduction for the full value of the donated property.

© The Regents of the University of California

§7.37 1. Income Test

The income test must be satisfied by all private operating foundations. It requires the foundation to spend substantially all of the lesser of its adjusted net income and its minimum investment return (5 percent of its investment assets) directly for the active conduct of the activities constituting the purpose or function for which the foundation was organized and operated. IRC §4942(j)(3)(A); Reg §53.4942(b)-1(a)(1)(ii).

The income generated by the foundation and the expenditures of funds must be for the direct activities of the foundation and not merely for the making of grants. Grants made to other organizations to assist them in conducting activities are considered an indirect, rather than a direct, means of carrying out activities constituting the charitable purpose of the foundation. Reg §53.4942(b)-1(b)(1). However, amounts paid to acquire or maintain assets that are used directly in the conduct of the foundation's exempt activities (the foundation's operating assets), such as works of art owned by a museum, are considered direct expenditures for the active conduct of the foundation's exempt activities. Those amounts also include administrative expenses. For example, if an individual was paid a fee to make sure that the foundation's works of art are properly insured, properly loaned to other organizations, properly stored when not on loan, and other related administrative activities, the fee is an expenditure directly for an exempt purpose. Reg §53.4942(b)-1(b)(1), (b)(2)(i), (d), Example 1.

In addition to meeting the income test, a private operating foundation must meet one of three alternative tests: the asset test (see §§7.38-7.39), the endowment test (see §7.40), or the support test (see §7.41).

© The Regents of the University of California

2. Asset Test

§7.38 a. Definition

The asset test requires the foundation to have substantially more than half of its assets devoted directly to the active conduct of activities constituting the foundation's charitable, educational, or other similar exempt purpose. IRC §4942(j)(3)(B)(i); Reg §53.4942(b)-2(a). The IRS regulations give an example of satisfying the asset test in order to qualify for private operating foundation status as follows (Reg §53.4942(b)-2(a)(6), Example 4):

> Z, an exempt organization described in section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80 percent of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings, such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph.

A donor can create a private operating foundation that can use the donor's name or any other name. The donor can contribute appreciated works of art to the private operating foundation and claim a deduction for the full market value.

WARNING: In making use of a private operating foundation, the donor-president of the foundation must be aware that its exempt status will be lost if *any* personal benefit inures to the donor. IRC §501(c)(3).

The donor, as president of the foundation, must arrange to lend the items to other public tax-exempt organizations so that the foundation can satisfy the asset test described above. The donor can contribute cash to cover operating expenses. The donor and any other individuals may be members of the board of directors. When the works of art are not on loan or exhibition, they should be placed in temporary storage. The objective is to be absolutely sure that the donor has created a private operating foundation retroactive to the date of formation—*i.e.,* the year in which the foundation is created—with the result that a deduction for the full fair market value of the donated art is allowable.

PRACTICE TIP: For a collector who wants the tax benefits of donating his or her art collection yet cannot cope with losing total *control* over the collection, a private operating foundation (by satisfying the income test and asset test) offers an alternative that should be given serious consideration. However, the collection should *never* be displayed in the donor's home. See IRC §4941; §7.39.

© The Regents of the University of California

§7.39 b. IRS Rulings on Asset Test

Revenue Ruling 74-498, 1974-2 Cum Bull 387, specifically dealt with the qualification of a foundation that owns art as a private operating foundation. The foundation was formed to further the arts. It owned a collection of well-known paintings, and had an endowment of stocks and bonds that produced income. Part of the income was used in a program of grants intended to further the arts, and the balance was used in a program of loaning paintings for display in museums, universities, and similar institutions. At any given time, all but a few of the paintings were in the hands of exhibiting institutions. Generally, when they were not on loan, the foundation's paintings were in transit, being reconditioned or restored, or being stored pending a scheduled exhibit. In that ruling, the IRS ruled that the foundation's collection of paintings was being used in an active loan program, and, therefore, it was being used directly to carry out its exempt purpose in the manner indicated in the IRS regulations.

A similar result was reached by the IRS in IRS Letter Ruling 9338042 (artwork acquired by nonprofit corporation was loaned to museums, galleries, and universities, thus accomplishing stated educational and charitable objectives). See also IRS Letter Rulings 8845059 (railroad museum's collection was used in the active conduct of charitable activity), 9236035 (planned loan of works of art is direct exempt activity and foundation qualified as private operating foundation). In that ruling, the IRS made it clear that the artwork that was placed on loan to other institutions was *excluded* in determining the foundation's minimum investment return. The minimum investment return is 5 percent of a foundation's investment assets and is the amount that a foundation must use or expend each year for exempt purposes. IRC §4942(a)(1), (e)(1); Reg §53.4942(a)-2(c)(1).

Because the exempt status will be lost if any personal benefit inures to the donor-president of the foundation (IRC §501(c)(3)), it is crucial to understand what use can be made of the collection when it is not on exhibition at other institutions. A donor often will want to know about the possibility of exhibiting the foundation's collection in his or her home or on real estate that he or she owns. The question is whether *any* of the art can be stored or exhibited in the donor's home when it is not on exhibition.

In Rev Rul 74-600, 1974-2 Cum Bull 385, paintings owned by a private operating foundation were on exhibition in various museums for a number of years and then were returned to the residence of the founder, where they were displayed together with the founder's large private art collection in a part of his residence devoted to paintings and other works of art. Approximately 2000 individuals visited the founder's private collection each year, and special tours were arranged for small groups and other individuals interested in the arts. The IRS ruled that the placement of the art in the founder's residence resulted in a direct use of the foundation's assets by or for the benefit of a private person, and, therefore, the foundation was not tax-exempt.

A similar result was reached in IRS Letter Ruling 8824001 dealing with sculptures that were outside on a taxpayer's residential property in a sculpture garden that was open to the public. The foregoing IRS position indicates how sensitive the government is to *any* personal use of art assets after the donation has been made.

If there is a separate structure on the donor's property, preferably a structure not attached to his or her residence, a ruling may be obtained that no personal use was made of the collection and that there was an exhibition space open to the public. Alternatively, the donor could build a storage space on his or her property and take the works of art out for conservation or for use in the storage space when scholars or other interested parties are in attendance. Reg §53.4942(b)-2(a)(6), Example 4; Rev Rul 74-498, 1974-2 Cum Bull 387.

WARNING: The collection should *never* be used in the donor's personal residence. The author strongly recommends that the items be placed in a storage facility, not on the donor's property, when the items are not on loan.

© The Regents of the University of California

§7.40 3. Endowment Test

The endowment test requires direct distributions of at least two-thirds of the foundation's minimum investment return —*i.e.,* 3.33 percent (⅔ × 5 percent) of its endowment. IRC §4942(j)(3)(B)(ii); Reg §53.4942(b)-2(b)(1). The distributions must be made directly for the active conduct of the foundation's exempt purpose. Most foundations that satisfy the income test will, as a practical matter, satisfy the endowment test in order to qualify as a private operation foundation.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.41 4. Support Test

§7.41 4. Support Test

The support test requires that:

- "Substantially all," *i.e.,* at least 85 percent, of the foundation's support, other than gross investment income, be from a combination of the general public and five or more exempt organizations (Reg §§53.4942(b)-2(c)(2)(ii), 53.4942(b)-1(c));
- Not more than 25 percent of support, other than gross investment income, be from any one exempt organization; and
- Not more than 50 percent of support be from gross investment income (IRC §4942(j)(3)(B)(iii); Reg §53.4942(b)-2(c)(1)).

The support test will rarely be used by a collector to qualify a foundation as a private operating foundation because of its fundraising requirements.

© The Regents of the University of California

§7.42 IV. COMPLETE TESTAMENTARY CHARITABLE TRANSFERS

An individual may desire to keep possession of a work of art during life and give it to a charitable organization on death. Doing so results in an estate tax charitable deduction to the extent of the full fair market value of the property at the date of death or, if applicable, on the alternate valuation date. IRC §§2032(b), 2055(a), (d).

In the case of a testamentary gift there is no distinction between a public charity and a private foundation. However, if the devise is to a private foundation that has not complied with the statutory requirement of including certain amendments in its governing instrument or that has failed to notify the IRS of its status, the entire estate tax charitable deduction will be denied. IRC §§508(d)(2), (a), (e), 2055(e)(1); Reg §20.2055-5(b).

Moreover, in general, the related use rule does not apply to testamentary transfers. IRC §170(e)(1)(B)(i); Reg §20.2055-1(a)(4). However, IRC §2055(e), introduced by the Economic Recovery Tax Act of 1981 (ERTA) (Pub L 97-34, 95 Stat 172), contains a related use rule for a testamentary charitable transfer when there is a retained copyright interest. That provision is discussed briefly in §7.43.

If the testator desires to make a testamentary gift of a work of art to a private foundation, the drafter of the will should obtain a copy of the foundation's governing instrument to ascertain whether the instrument meets the statutory requirements, and should also obtain a statement from the organization that it has notified the IRS of its status.

Outright testamentary charitable transfers:

- Allow the art collection to be kept together as a unit;
- Eliminate the problem of raising the money necessary to pay the estate taxes attributable to the inclusion of a valuable art collection in the gross estate; and
- Eliminate any need for a forced sale of the art collection in order to pay the estate taxes.

A testator who wishes to give a work of art to a charitable organization should make a specific gift in his or her will. The gift should be specific enough to identify clearly the property to be given. The gift should always include "any copyright interest, if any" in order to avoid an inadvertent split interest transfer or other problem under IRC §2055(e)(4)(C). See §7.43.

The testator should consider the possibility that a specific charitable organization may renounce the gift. Therefore, the proposed gift and any conditions attached should be discussed with the charitable organization. For a specific gift of a work of art, see form in §7.66.

WARNING: The amount of the charitable deduction will be reduced if estate taxes or certain other items are chargeable against the gift to charity. See IRC §2055(c). The drafter should be careful to avoid any such charges against the gift to charity unless that is the testator's intention. If federal estate tax is payable from property passing to charity, an algebraic computation is required to compute the amount of the charitable deduction because the amount of the deduction depends on the tax payable out of the property passing to charity, and the amount of the tax payable likewise depends on the amount of property passing to charity. For a discussion of computing the charitable deduction when estate taxes are charged against the gift to charity, see *Estate of Bush v U.S.* (Ct Cl 1980) 618 F2d 741.

© The Regents of the University of California

§7.43 V. RETAINED COPYRIGHT INTEREST

The tax regulations have always treated a work of art and the copyright as two interests in the same property. The United States Copyright Law treats a work of art and the copyright as two separate property interests. A federal statutory copyright for a work of art comes into existence at its creation. This made it impossible to obtain a charitable deduction for a work of art transferred to a charity if the decedent retained the copyright interest for his or her heirs because there was not a complete transfer of the property. Internal Revenue Code §2055(e)(4) is an attempt by Congress to allow some flexibility in that area. (§423 of ERTA amended IRC §§2055(e) and 2522(c).) See also Reg §§20.2055-2(e)(1)(ii), 25.2522(c)-3(c)(1)(ii).

For decedents dying after 1981, a work of art and its copyright are considered separate properties for purposes of the estate tax charitable deduction. IRC §2055(e)(4)(A). Consequently, under limited circumstances, a charitable deduction is allowable for a testamentary gift of an art work to charity whether or not the copyright is also given to the charity. A "work of art" is defined in IRC §2055(e)(4)(B) as any tangible personal property that is copyrighted under federal law. The deduction is limited to qualified contributions defined under IRC §2055(e)(4)(C), which requires that the art work's use be related to the purpose or function constituting the basis for the organization's exemption under IRC §501.

That rule is similar to the IRC §170(e)(1)(B)(i) related use rule. A contribution is a "qualified contribution" for purposes of the retained copyright provision only if the IRC §2055(e)(4)(C) related use rule is satisfied. If the contribution is not a "qualified contribution," the old split-interest rule applies, *i.e.,* the work of art and the copyright are treated as two interests in the same property, rather than as two separate property interests.

The statute applies only to qualified contributions made to a "qualified organization." IRC §2055(e)(4)(D). The term "qualified organization" means any organization described in IRC §501(c)(3) other than a private foundation under IRC §509. For that purpose, a private operating foundation under IRC §4942(j)(3) is not treated as a private foundation. Under IRC §2055(e)(4), therefore, a decedent is allowed to make a transfer of a work of art to a qualified charitable organization, with his or her estate retaining the copyright interest, as long as the transfer satisfies the estate tax related use rule of IRC §2055(e)(4)(C).

Generally, when a collector purchases a work of art, he or she is purchasing it without the copyright because the artist retains the copyright unless it is specifically transferred in writing. Consequently, when the collector makes a testamentary transfer of a work of art to a charitable organization, the collector need not worry about satisfying the related use rule of IRC §2055(e)(4)(C) if he or she has never owned the copyright interest.

AUTHOR'S ADVICE: To be on the safe side, regardless of whether or not the collector owned the copyright interest, the charitable gift should contain specific language to the effect that the copyright is included in the transfer in order to avoid any possibility of running afoul of the related use rule of §2055(e)(4)(C).

An artist, however, who wants to give a work of art under his or her will to a charitable organization must either (1) transfer the work of art and the copyright or (2) transfer the work and retain the copyright interest if the related use rule of §2055(e)(4)(C) is satisfied.

Section 2055(e)(4) is a benefit for the artist who wants to devise works of art to a charitable organization and retain the copyright for reproduction purposes for the artist's heirs. Before January 1, 1982, that could not be done. If the artist wants to devise a work of art to a charitable organization, but does not intend to retain the copyright interest, care must be taken to make sure that both the work of art and the copyright are specifically transferred to the charity. Otherwise, the statute is a trap for the unwary artist, whose estate tax charitable deduction may fail because of the related use rule of §2055(e)(4)(C).

PRACTICE TIP: For collectors, IRC §2055(e)(4) presents no problem as long as the collector does not own the copyright. However, in preparing a will for a collector, an attorney should take care to make sure that if the collector does own any copyright interest, it is transferred to the charitable organization along with the work of art.

For a broader discussion of estate planning for copyrights, see chap 8.

© The Regents of the University of California

§7.44 VI. VALUATION

Knowing the value or approximate value of a work of art is of utmost importance:

- For income tax purposes if the work is transferred during life to a charitable donee (Reg §§1.170A-1(a), (c), 1.170A-13);
- For gift tax purposes if the work is transferred during life to a noncharitable donee (Reg §25.2512-1);
- For estate tax purposes if the work is owned at death (Reg §20.2031-6); and
- For insurance purposes if the work is maintained during life (insurance companies require an appraisal in order to determine the premiums for coverage).

As important as the concept of value is, there is no simple rule or answer. Although, as discussed in §7.45, the IRS has by regulation attempted to create rules of valuation, those rules are not workable in all situations and are most difficult to apply when it comes to unique works of art.

© The Regents of the University of California

§7.45 A. IRS Valuation Regulations

The IRS valuation regulations for estate, gift, and income tax contain certain parallel provisions, although they are not consistent in every respect. Reg §§20.2031-6, 25.2512-1, 1.170A-1(c)(2).

The estate tax regulation defines fair market value as "the price which a willing buyer would pay to a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Reg §20.2031-6.

The gift tax and income tax regulations contain identical language. Reg §§25.2512-1, 1.170A-1(c)(2). The hypothetical sale must be in the market in which such property is most commonly sold to the public. See *Ronald P. Anselmo* (1983) 80 TC 872, aff'd (11th Cir 1985) 757 F2d 1208. When trying to place a value on a unique work of art, those guidelines do not offer much help. The regulations contemplate a retail market that may not exist when one is dealing with collectibles.

Regulation §20.2031-1(b) gives the example of a used car to illustrate which market is to be considered retail. The regulation provides that the market value is the market price at which the general public can buy the car—not the wholesale price the dealer can pay for the car. When dealing with an average automobile, there is no problem, because a market exists for its sale. However, if the automobile is a rare antique, such a market may not exist. The contemplated "retail market" rule of Reg §20.2031-1(b) is an attempt by the IRS to formulate a simple rule when one does not fit. Similar language is included in gift tax Reg §25.2512-1 and in income tax Reg §1.170A-1(c)(2).

For estate and gift tax deduction purposes, an appraisal is required for tangible personal property having an artistic or intrinsic value in excess of $3000. Reg §20.2031-6(b). For income tax deduction purposes, a qualified appraisal is necessary if the claimed value exceeds $5000. See §7.19.

© The Regents of the University of California

B. Determining Fair Market Value

§7.46 1. IRS Practice in Determination of Value; IRC §7517

The IRS appoints an advisory panel of art experts to assist it in evaluating appraisals of donated works of art and cultural property submitted by taxpayers to support income, gift, and estate tax valuations. See Int Rev Man 4.48.2. If a return selected for audit includes art or cultural property with a submitted valuation of more than $20,000 per item, the local audit office will send the appraisal to Art Appraisal Services for review by the Art Advisory Panel. Int Rev Man 4.48.2.1. The Art Advisory Panel makes recommendations on the acceptability of the valuations submitted. If the panel finds the valuations unacceptable, it makes alternate valuation recommendations. Although the recommendations issued by the Art Advisory Panel are advisory only, they become the position of the IRS. Int Rev Man 4.48.2.1.1.

Unfortunately, because of the enormous volume of referred cases, having a request processed through the national office in Washington, D.C., often takes from six months to one year. The Art Advisory Panel only meets twice a year. The taxpayer's documentation, therefore, must be as complete as possible before submission. Taxpayers who believe the Panel did not review the submitted items correctly can request resubmission to the Panel. Int Rev Man 4.48.2.1.1. Taxpayers must provide the Panel with any additional documentation that indicates why the Panel may have been in error.

Internal Revenue Code §7517 provides that the IRS must, on written request by a donor or executor, furnish a written statement explaining the basis on which the IRS has determined or proposes to determine a valuation of property that is different from the valuation submitted by the donor or the executor. That section applies to all valuation issues, whether the donation involves a lifetime transfer or a testamentary transfer to a charitable or a noncharitable transferee. The reason is to encourage the resolution of valuation issues at the earliest possible time, which can best be achieved if all parties have full information on how the others arrived at the valuation. The IRS must furnish its statement within 45 days of the date of the request or the date of its determination (or proposed determination), whichever is later. The IRS statement must (1) explain the basis on which the valuation was determined or proposed, (2) set forth any computation used, and (3) contain a copy of any expert appraisal made by or for the IRS. The statute specifically provides that the IRS statement is not intended to be a final or binding representation of the IRS position.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.47 2. IRS Advance Ruling Procedure

§7.47 2. IRS Advance Ruling Procedure

Revenue Procedure 96-15, 1996-1 Cum Bull 627 allows the taxpayer, *after* a transfer of a work of art (during lifetime or at death) but *before* filing the applicable return, to request an advance review of art valuations for income, gift, and estate tax purposes. The request for a Statement of Value is generally available for artwork appraised at $50,000 or more and must include:

- A copy of a detailed appraisal of each item of art, obtained by the taxpayer (see Rev Proc 96-15 for specific appraisal requirements);
- A user fee of $2500 for the first three items transferred and $250 for each additional item;
- IRS Form 8283.

NOTE: The IRS may issue a Statement of Value for items of art appraised at less than $50,000 if the request includes at least one item that has a value of $50,000 or more.

Once the IRS issues a Statement of Value under Rev Proc 96-15, it must be attached to the taxpayer's return and is binding on the IRS. If the taxpayer disagrees with the IRS determination, the taxpayer may submit additional information with his or her tax return in support of a different value. The procedure should be appealing to taxpayers interested in a high degree of certainty when filing their returns.

© The Regents of the University of California

§7.48 C. Litigating Fair Market Value

The question of the fair market value of a work of art is difficult and must rest on expert appraisals. Resolving valuation disputes with the IRS, as demonstrated by the litigated cases, can be a time-consuming and expensive proposition.

Evidence of IRS willingness to litigate charitable contribution schemes that have no economic reality is found in several cases, *e.g., Ronald P. Anselmo* (1983) 80 TC 872, aff'd (11th Cir 1985) 757 F2d 1208 (see §7.49). See also *Quintin U. Ford,* TC Memo 1983-556.

Auction prices are not the absolute measure of fair market value. In *Raymond Biagiotti,* TC Memo 1986-460, involving the valuation of Mayan and other pre-Columbian art, the Tax Court observed that Sotheby's auction sales did not represent a significant portion of the sales of such art in the United States and did not accurately represent the average sale prices of that art. The court found that a better measure of value was what collectors paid private dealers because collectors rely on dealers' guarantees of authenticity, and auction houses do not guarantee authenticity.

© The Regents of the University of California

1. Relevant Market

a. Wholesale Market

§7.49 (1) Relevant "Retail Market" Can Be Wholesale Market

In *Ronald P. Anselmo* (1983) 80 TC 872, aff'd (11th Cir 1985) 757 F2d 1208, the taxpayer purchased colored gemstones and donated them after the long-term capital gain holding period had been satisfied. The Tax Court found that members of the public did not generally purchase unset gems; rather, the usual consumers of unset gems were manufacturing and retail jewelers who used them to create jewelry. The Tax Court looked to the regulations and the definition of "retail market" to measure fair market value. The court found that the retail market in which to find comparable values for the donated gems was the market in which the jewelry stores made their purchases and not the market in which an individual member of the public made a purchase at the jewelry store. In effect, the Tax Court said there can be more than one "retail market," and the market that is closest to the taxpayer's activities is the market the court will look to for comparable values. See also *Dale B. Dubin*, TC Memo 1986-433. The court further held that a separate fair market value should be determined for each unit of property donated.

© The Regents of the University of California

§7.50 (2) Relevant "Retail Market" Is Middleman Market; Donation of Bargain Property

The case of *Samuel E. Hunter,* TC Memo 1986-308 involved a taxpayer who purchased a group of high quality prints by prominent artists and donated them to various charities. Marlborough Gallery sold the prints in bulk to a middleman, who was able to buy them at one-sixth of Marlborough's retail list price because Marlborough was disposing of excess inventory. The art was not unsalable, and, in fact, Marlborough retained a number of the prints for sale to the public at its normal retail price. The middleman then resold the prints to the taxpayer at one-third to one-fourth of Marlborough's list price. The taxpayer, however, claimed a charitable deduction for the Marlborough list price of each print.

The Tax Court held that the transaction was not a sham and that it was not relevant that the taxpayer never took possession of the prints. It further dismissed the IRS contention that the blockage discount applied, because the number of prints was small.

The court concluded, however, that the deduction for the taxpayer was limited to what he paid for the prints. The court reasoned that the relevant "retail market" was the market in which the middleman had sold the prints to the taxpayer, *i.e.,* the market in which the taxpayer had made his purchase. Perhaps a different result might have been reached if the taxpayer had made his purchases directly from Marlborough Gallery, rather than through a middleman. The case indicates that whenever a purchase and a donation are close in time, the IRS will give the charitable deduction careful examination. See also *Raymond Dean Jennings,* TC Memo 1988-521.

That does not mean that if someone finds a bargain he or she cannot donate the property. In *Bernard Lightman,* TC Memo 1985-315, the taxpayer made an advantageous bulk purchase of a number of works of art by one artist and donated the paintings to a museum shortly after one year from their purchase. The court recognized that the taxpayer had been given a price concession on the purchase and that their cost was not indicative of the values of the individual paintings. Instead, the court used auction prices of other paintings by that artist as the measure of market value for donation purposes. See also *Herman v U.S.* (DC Tenn 1999) 73 F Supp 2d 912 (medical equipment purchased at bankruptcy sale valued at 25 times taxpayer's cost). For a case involving the advantageous purchase of a gemstone followed by its contribution, see *James H. Rhoades,* TC Memo 1988-279.

© The Regents of the University of California

§7.51 b. Retail Market With Blockage Discount

In *Richard A. Skripak* (1985) 84 TC 285, the Tax Court upheld the validity of a book contribution program, but substantially lowered the value of the books contributed. In *Skripak,* the taxpayer participated in a charitable contribution tax shelter promoted by Reprints, Inc. Reprints identified libraries to receive books and contributors who would contribute the books to the libraries. The contributors bought the books from Reprints at one-third of the normal price and, after holding them for longer than six months (the applicable capital gains period), contributed them to libraries at their retail price. The court held that the contributions were legitimately made and were not a sham, as alleged by the IRS. However, the court further held that the books had a value of only 20 percent of the retail price, less than the amount the contributors actually paid for them.

The *Skripak* case makes it clear that a taxpayer may participate in a tax shelter that is motivated solely by the goal of obtaining a charitable deduction without having the deduction disregarded on the ground that the shelter is a sham. However, taxpayers entering into such shelters risk having the amounts of their deductions reduced if the donated properties are not properly valued, and the taxpayers could lose money because the donated properties could be found to have a value of less than they paid for them. In *Skripak,* the court still looked to the "retail market" for the valuation of the books, but applied a "blockage discount" because the simultaneous marketing of all the books would substantially depress the market for the books. A "blockage discount" is a reduction in market value based on the theory that a large number of similar items offered for sale at one time distorts the market value and results in a reduced market value. See also *Louisa J. Calder* (1985) 85 TC 713.

© The Regents of the University of California

§7.52 c. Market Data Comparison Approach

The case of *Gifford M. Mast, Jr.,* TC Memo 1989-119 involved determining the fair market value of glass stereoscopic negatives, a photographic viewing technique popular between the mid-19th century and the mid-20th century. The taxpayer had a large collection of glass stereoscopic negatives and donated them to the University of California, claiming an income tax deduction of $1,544,000, based on the appraiser's estimated replacement costs. The IRS initially ruled that the value was zero.

The taxpayer presented two additional experts at trial, one a professional appraiser and a senior member of the Appraisers Association of America and of the American Society of Appraisers, and the other expert a full-time dealer. The professional appraiser testified that there are "a number of distinct approaches to valuation; the income approach, the cost estimate approach, the revenue approach and the market data comparison approach." *Gifford M. Mast, Jr.,* 56 TC Memo at 1525. Using the market data comparison approach, the appraiser estimated the value of the collection at $1.59 million. That method of valuation is based on comparisons with reported sales, offers to sale by catalog, showroom and gallery pricing, and historic data. The appraiser contacted leading galleries and auction houses for estimates about the collection's replacement value. The dealer valued the collection at $1.2 million on the basis of what he thought the items in the collection could be sold for.

The IRS used a full-time professional appraiser but retained her only shortly before trial, so her analysis was less thorough than the taxpayer's appraiser. Her valuation approach was to compare the donated collection with allegedly comparable photographic collections that had been sold. She concluded that the collection had a value of $450,000.

The court, in reaching its conclusion, first reiterated the traditional "willing buyer and willing seller" test of Reg §1.170A-1(c)(1). The court stated that fair market value is a question of fact to be determined from an examination of the entire record and concluded that the market data comparison approach used by the taxpayer's expert seemed the most reasonable. The court noted that the IRS expert used a valuation method that differed substantially from that used by the taxpayer's experts. Rather than use a market data comparison approach, the IRS expert determined fair market value on the basis of the sales of five allegedly comparable collections. The court stated that, before that approach can be used, it must first be determined whether the collections were, in fact, comparable. The court decided that the IRS expert relied on collections that were not comparable, and gave little weight to the IRS expert's testimony. In reaching its holding that the fair market value of the glass stereoscopic negatives was $1.25 million, the court pointed out that questions of fair market value are properly resolved through settlement negotiations, rather than litigation:

> In the absence of settlement, we are left to adjudicate the validity of conflicting experts' opinions who are convinced that both their conclusions and methods are correct. The result is an over-zealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement. [*Morris M. Messing* (1967) 48 TC 502, 512, acq 1968-2 Cum Bull 2.]

On appeal, the court found the IRS liable for $25,000 in legal fees because it was unreasonable for the IRS to have determined, without the advice of an expert, that the collection had a zero value and to stick with that determination throughout trial, even though the IRS had no evidence to support its position while the taxpayer had provided the testimony of three qualified appraisers, who valued the collection near the same amount as that claimed by the taxpayer. *Gifford M. Mast, Jr.,* TC Memo 1989-438.

© The Regents of the University of California

d. Relevant Retail Market: Art Galleries or Auction Sales

§7.53 (1) Relevant Retail Market Is Art Galleries

In *Heriberto A. Ferrari,* TC Memo 1989-521, the issue involved the valuation of 21 pieces of pre-Columbian art donated to the Duke University Museum of Art and to the Mint Museum of Art. The case, which is similar to *Raymond Biagiotti,* TC Memo 1986-460 (see §7.48), discusses the proper marketplace for determining comparable sale prices of pre-Columbian art. The court pointed out that the market to be looked at for comparable sales is the retail sales market at art galleries, not auction sales.

When purchasing pre-Columbian art or antiquities, most buyers want to rely on the guarantee of authenticity and the connoisseurship of the art dealer; unless the buyers themselves are dealers or experts, they do not want to buy at auction, where the purchased antiquity may not be covered by any warranty of authenticity. The *Ferrari* opinion includes an excellent discussion of what to look for in determining value. Value is determined by the condition, the uniqueness, or the rarity of the item, its authenticity, its size, and the market value of comparable objects. In noting that retail gallery prices are the correct comparable marketplace, the court found that different galleries price even the same or similar objects at different levels. Therefore, the court found that fair market value, as defined by the IRS regulations, is in this case not a single price but a range of prices, not necessarily the highest price at which an object would change hands between a willing buyer and a willing seller. The court expressed astonishment that the parties did not seek an arbitrated solution by an art expert rather than litigation in the Tax Court.

NOTE: Any appraiser hired in a valuation case or for appraising property to be donated to charity must be fully familiar with the proper marketplace to be selected for finding comparable sale prices to support the valuation of the donated property.

© The Regents of the University of California

§7.54 (2) Relevant Retail Market Is Auction Market

The estate tax value of tangible personal property can be based on public auction sales made within a reasonable time of the valuation date, provided there have not been any substantial changes in market conditions. Rev Proc 65-19, 1965-2 Cum Bull 102.

In *Thomas G. Murphy,* TC Memo 1991-276, rev'd on other grounds (9th Cir 1993) 1993 US App Lexis 26485 (namely negligence penalty did not apply), a case involving the valuation of what was known as "the million-dollar rock," a sandstone rock sculpture that depicted the face of John Wayne, the court accepted the appraisal of the IRS expert who used documented auction sales for comparable prices. The court noted that the taxpayer's valuation of $500,000 was based on an appraisal that failed to discuss the condition of the sculpture and failed to verify the accuracy of comparable prices. The IRS expert pointed out that the sculpture was in extremely poor condition, missing the left temple, left eyebrow, a large wedge-shaped area below the left eye, the left cheek, and part of the left chin. Finding the IRS expert more credible, the court valued the sculpture at $30,000. The case is also instructive in that the gift was donated on the condition that it not be sold or otherwise disposed of for two years after its receipt and that restriction, the court found, reduced the fair market value of the donated sculpture. But see IRS Letter Ruling 200418002, discussed in §7.60, in which restrictions on transferring art did not reduce the art's value for estate tax deduction purposes.

NOTE: Tangible property (works of art) that are donated to a charity and disposed of by the charity within two years of receipt are required to be listed on IRS Form 8282, revealing the name, address and social security number of the donor and the price at which the charity disposed of the property.

© The Regents of the University of California

§7.55 e. Collector's Market

The case of *Jack C. Chou,* TC Memo 1990-90 involved the fair market value of a carved opal donated to a museum. In 1982 the taxpayer had purchased a rough opal for $19,500. The taxpayer returned the opal to the seller to be carved and then donated it 13 months later to a museum. The seller recommended two appraisers to the taxpayer; they appraised the donated, now carved, opal at an average value of $300,000. The court, in holding that the value was $30,000, noted that the opal was purchased only a little more than a year before it was donated and that cost is important evidence of value when no intervening factors explain a substantial or unusual appreciation.

In reaching its conclusion, the court stated that it had to determine the appropriate market for purposes of valuation and that the determination was a question of fact. The court stated that, in valuing gemstones, the market may be retail, wholesale, or a "collector's market." The court dismissed the wholesale market because the taxpayer was not a dealer in gemstones and concluded that only values from the collector's market were appropriate. The court relied on testimony of the IRS expert that the appropriate marketplace was the collector's market because a knowledgeable buyer would not pay the higher retail prices, and the record indicated that the taxpayer was a knowledgeable, albeit amateur, collector.

In the author's opinion, the analysis in *Jack C. Chou* is incorrect to the extent it relies on a so-called collector's market for comparable values. The court's opinion seems to imply that a knowledgeable taxpayer would get a lower income tax deduction for a donation than would a less informed taxpayer who did not know what he or she was doing. Whether a taxpayer is knowledgeable or not should not be a determining factor in the amount of the charitable deduction. The amount of the deduction should depend on the value of the item, based on comparable sales in the most appropriate marketplace in which the item is most commonly purchased and sold.

In *Fuad S. Ashkar,* TC Memo 1991-11, the court also determined that the appropriate market for valuing a sale of ancient biblical fragments was the so-called collector's market. In *Ashka,* the court relied on evidence of a $337,500 offer that had been made for the collection. The court found the valuations of the IRS's expert ($25,000) and the taxpayer's expert ($700,000) to be unpersuasive, noting that the experts were academic scholars, rather than professional appraisers of ancient documents. See also *Paul W. Holtzman,* TC Memo 1980-174 (in determining value of ancient Greek coins, court gave less weight to testimony of tenured professor and art museum curator than to coin dealers).

© The Regents of the University of California

§7.56 f. Comparable Sales Prices

In identifying the appropriate marketplace to find comparable sales, the case of *Joseph M. Isaacs,* TC Memo 1991-473 is illustrative. *Isaacs* involved a bulk purchase of Alexander Calder-designed tapestries that were handwoven by Guatemalan Indians. The tapestries were purchased for $900 each and were donated at a value of $10,000 each. The IRS argued that, in the most common marketplace in which a group of the tapestries would sell, the price would be deeply discounted below the wholesale price. That was the same theory argued in *Samuel E. Hunter,* TC Memo 1986-308 (see §7.50), involving a donation in bulk of a group of lithographs. The court held that the tapestries were worth $3000 each, based on the court's own determination of fair market value and comparable sale prices from the testimony of the various experts.

© The Regents of the University of California

§7.57 g. "Glamour" Premium

In *Franklin P. Perdue,* TC Memo 1991-478, the court ruled that in determining the fair market value of gold artifacts recovered from an historic shipwreck, a premium could be added for the excitement and glamour associated with the artifacts. The court stated that neither IRC §170 nor its regulations specify which market a taxpayer should use to calculate fair market value.

NOTE: The regulations that refer to a "retail market" are contained in the estate tax regulations (Reg §20.2031-1(b)) and technically do not apply to the income tax donation sections of the Internal Revenue Code, although it is the author's understanding that it is IRS policy to treat the estate tax regulations as though they applied equally for estate tax and income tax purposes.

The IRS expert argued that the numismatic or precious metals market was the appropriate market for determining the fair market value of the artifacts, not the retail museum or gift shop market, because the "glamour market" consisted of unknowledgeable buyers. The court recognized, however, that the enhanced prices obtained from sales at museum shops and auctions reflected a different focus, not a lack of knowledge and ruled that the "romantic appeal and glamour" of the artifacts were "appropriately considered" in valuing the artifacts.

© The Regents of the University of California

§7.58 h. Authenticity Dispute Depresses Value

The case of *George O. Doherty,* TC Memo 1992-98, aff'd (9th Cir 1994) 16 F3d 338, pitted the two foremost authorities on the paintings of Charles M. Russell. The taxpayer had donated a painting to the Charles M. Russell Museum and had valued it at $200,000. The IRS said that the painting was a forgery and was worth only $100. The court noted that the credentials of the two experts were beyond question, yet they reached different conclusions. The court declined to rule on the authenticity of the painting in the light of the fact that the two experts could not agree on its authenticity. In reaching its conclusion that the painting had a value of $30,000, the court recognized that a dispute over the authenticity of a painting depresses its value.

© The Regents of the University of California

§7.59 i. Valuation of Stolen Property

An interesting twist to the identification of the proper market in which to value works of art is discussed in IRS Letter Ruling 9152005. The ruling closely follows the facts in what became known in the newspapers as the story of the Quedlinburg Treasures. In 1945, the decedent's U.S. Army unit was placed in charge of guarding some rare medieval art objects in Germany. The decedent stole and shipped the art objects to his home in Texas. When he died in 1980, his Texas inheritance tax return did not list any of the art objects. No federal estate tax return was filed even though the art objects had a value of many millions of dollars.

The IRS ruled that under IRC §2033 the stolen art was includable in the decedent's gross estate and had to decide how the art property should be valued. The decedent's attorney argued that the proper market for valuation purposes was the illicit market in which stolen art objects are regularly sold and that because there was no market for stolen medieval art objects, the value of the property must be zero. The IRS rejected that argument, analogizing, in part, to income tax cases in which the IRS had placed a value on cocaine and marijuana by referring to its street-market price. The IRS concluded that the fair market value of the art objects was the highest price that would have been paid at the time of the decedent's death, either in the illicit stolen-art market or in the legitimate art market.

The decedent's attorney then argued that if the objects were includable in the gross estate at their fair market value, the decedent should be entitled to claim a deduction under IRC §2053(a)(3) for claims against the estate by the legitimate owners of the art objects. The IRS rejected the deduction, noting that, in order to be enforceable under Texas law, a claim had to be submitted within a certain period of time, which had passed, and that IRC §2053(a)(3) provides that claims against an estate are allowable only to the extent that they are allowable by the laws of the jurisdiction under which the estate is administered.

© The Regents of the University of California

§7.60 2. Estate Inclusion Value Consistent With Deduction Value

In general, the amount allowable as an estate tax charitable deduction under IRC §2055 is the date of death (or alternate valuation date) fair market value of the property passing to charity. In certain instances, this value may not be the same as the value determined for estate tax inclusion purposes under IRC §2031. See, *e.g., Ahmanson Found. v U.S.* (9th Cir 1981) 674 F2d 761; *Estate of Marvin M. Schwan,* TC Memo 2001-174; *Estate of Frank M. DiSanto,* TC Memo 1999-421; *George Deukmejian,* TC Memo 1981-24; *Jacob J. Cooley* (1959) 33 TC 223, aff'd (2d Cir 1960) 283 F2d 945. These cases deal with the effect of restrictions on marketability and the restrictions may affect the estate tax or income tax charitable deduction in the context of restricted securities.

In IRS Letter Ruling 200418002, the IRS ruled that the restrictions on a devise of an art collection to a museum and foundation will not cause the charitable deduction to be lower than the value at which the collection would be included in the decedent's estate. The estate plan of the husband and wife (donors) provided that the first to die would leave the art collection, plus a building ("gallery") that would be used to display the collection, outright to the survivor. The survivor would then devise the collection to a museum and devise the gallery plus cash to the foundation. The donors had entered into a agreement ("agreement") with the museum and the foundation that would apply if the surviving donor transfers the collection and the gallery according to the agreement. Under the agreement, the museum could not sell any of the art collection and could loan art in the collection only under specially defined circumstances. The museum was also required to display and maintain the art collection in accordance with the terms and conditions of the agreement. If the museum violated the restrictions, the art collection would be transferred to the foundation. Therefore, there was no possibility that the art collection would revert to the donors or inure to the benefit of any private individual.

NOTE: Consistent with the IRS's private letter rulings on fractional transfers to charity (see discussion in §7.27 and IRS Letter Ruling 200223013) the IRS ignored the numerous restrictions on the museum's use of the art collection and ruled that the survivor of the donors could deduct the art collection at its full fair market value, which is the value at which it would be included in the survivor's gross estate. The IRS seems to treat artwork differently from securities and real estate in ignoring restrictions of the use of such property for valuation purposes. This is helpful to a taxpayer claiming an income tax deduction for a donation of artwork to a museum or an estate tax deduction for a bequest of artwork to a museum. However, if the taxpayer is gifting or devising artwork to a family member, these restrictions will not be helpful in reducing the value of the artwork. This letter ruling is somewhat surprising —particularly because it treats the valuation issue as a question of law.

© The Regents of the University of California

§7.61 D. Trend in Valuation Cases

The trend in valuation cases indicates that settlement is clearly the best course of action. Settlement is best achieved by being initially careful and thorough in the selection of the appraiser and by making sure that the appraisal complies with all the requirements of the IRS regulations. Most important, the appraisal should show comparable prices and identify the proper marketplace for valuing the donated property. Being thorough and complete at the time of a donation will best enable the taxpayer to sustain the value of the donated property and avoid expensive litigation.

For other valuation cases, see *Myron G. Sammons* (9th Cir 1988) 838 F2d 330 (Indian artifacts); *Saltzman v U.S.* (ED NY 1988) 750 F Supp 61 (videotape of Bolshoi Ballet); *Chronicle Publishing Co. v Commissioner* (1991) 97 TC 445, aff'd (5th Cir 1993) 983 F2d 232 (unpublished opinion) (newspaper clipping library); *James L. Winokur* (1988) 90 TC 733, acq 1989-2 Cum Bull 1 (paintings); *Raph Neely* (1985) 85 TC 934 (African art; see Teitell, *Deductions for African Art*, NY LJ 1 (Mar. 17, 1986)); *Frederick C. Johnson* (1985) 85 TC 469 (Indian artifacts); *Peter J. Lio* (1985) 85 TC 56 (lithographs); *William Glen* (1982) 79 TC 208 (tape recordings of interviews with noted scientists; IRC §170(e)(1)); *Jearold E. Arbini,* TC Memo 2001-141 (value of bound newspapers); *Samuel Jacobson,* TC Memo 1999-401 (first-day covers and religious books); *Bruce Korson,* TC Memo 1998-132 (coin collection ledgers); *George H. Engel,* TC Memo 1993-362 (wild game trophy mounts); *Robert E. Bronson, III,* TC Memo 1992-122 (art master tax shelter); *Dorian M. Bennett,* TC Memo 1991-604 (value of piano and when gift is effective); *Albert Victor Mills,* TC Memo 1991-592 (vintage car); *William E. Straw*, TC Memo 1991-524 (value of horse); *Estate of Darwin A. Miller*, TC Memo 1991-515 (animal hunting trophies); *Robert A. Hall*, TC Memo 1990-127 (vintage football film collection); *Thomas J. Baker,* TC Memo 1990-263 (videotapes of surgeons' operations); *Harry D. Mandelbaum,* TC Memo 1990-223(art master tax shelter); *Robert L. Sanz,* TC Memo 1990-568 (foreign language books); *Daniel I. Rhode,* TC Memo 1990-656 (value of books); *John V. Wehausen* (1988) TC Memo 1988-460 (valuation of mathematical journals); *Richard E. Frates,* TC Memo 1987-79 (paintings and sculpture); *Raymond Biagiotti,* TC Memo 1986-460 (Mayan and other pre-Columbian art objects); *Richard B. Skala,* TC Memo 1985-1 (vintage aircraft); *Noris W. Krauskopf,* TC Memo 1984-386 (racing car); *Larry M. Isbell,* TC Memo 1982-534 (Han Dynasty ceramic jar); *Alexis M. Hawkins,* TC Memo 1982-451 (mosaic table purchased from Vatican Studio); *Clifton E. Peterson,* TC Memo 1982-438 (ivory carvings); *Bodizar M. Raznatovich,* TC Memo 1980-436 (unindexed negatives of aerial photography); *Gerald D. Leibowitz,* TC Memo 1977-243 (movie memorabilia).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.61A E. Basis for Purposes of Sale

§7.61A E. Basis for Purposes of Sale

One of the most important tax consequences of death is that property included in a decedent's gross estate for federal estate tax purposes acquires a step-up in basis for income tax purposes equal to its federal estate tax value, *i.e.,* the fair market value of the property at the date of the decedent's death or the alternate valuation date. IRC §1014. In other words, if a collector purchased a painting for $10,000 and the painting is valued at $100,000 for federal estate tax purposes on the collector's death, the heirs will acquire the painting with a step-up in basis equal to $100,000. The fair market value of the property as of the date of the decedent's death or as of the alternate valuation date is deemed to be the value of the property "as appraised for purposes of the federal estate tax." Treas Reg 1.1014-3(a).

Conrad Janis, TC Memo 2004-117 is an example of a case in which a taxpayer wanted to have his cake and eat it, too. Here the decedent, the well-known New York City art dealer Sidney Janis, died owning many works of art in the gallery that he ran as a sole proprietorship. The IRS Art Panel first determined the total value of the works of art owned at death based on a per item appraisal submitted by the executors. The panel then allowed a discount based on various business reasons and then agreed to further apply a blockage discount. The panel first acknowledged that the blockage concept generally applies to a large number of works by one artist, usually in an artist's estate. It then went on to apply some of the general blockage discount principles to the gallery's inventory as follows:

> Consideration was given to the prominence of the artists; the types of works in the estate; the distribution of the items (for example, the number and types, and their quality and saleability); the number of similar items available in the marketplace; the market's response to such works around the valuation date; the number of sales and the prices at which sales were made during the period immediately preceding and following death; the annual sales of the gallery; length of time necessary to dispose of the items; the works that are saleable within a relatively short period of time; the works that can only be marketed over a long period; the demonstrated earning capacity of the business; the tangible and intangible assets, including goodwill; and the reputation of the gallery and the provenance.

This resulted in a further 37-percent reduction of the value of the gallery's inventory or a total combined discount of approximately 60.42 percent. This was a great success for the taxpayer—but it was not enough.

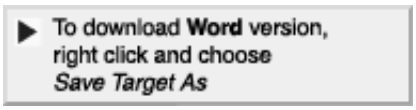
When the heirs of the estate sold some of the artworks, they used as their new stepped-up basis the original per item appraised value accepted by the IRS Art Panel *before* the application of the 60.42-percent discount. The heirs argued that the term "appraised value" in Treas Reg §1.1014-3(a) refers to the undiscounted fair market value because the discount determined by the IRS Art Panel was attributable to the collection as a whole and did not apply in determining the value of each work of art sold separately. In addition, the heirs argued that *Elizabeth G. Augustus* (1939) 40 BTA 1201, aff'd (6th Cir 1941) 118 F2d 38, a 1939 case dealing with the sale of stock, supported the use of the undiscounted value for income tax purposes. The Tax Court distinguished *Augustus* and found that because the substantive effect of the blockage discount was to establish a proportionate value for each work of art in the collection, it follows that the "appraised value" contemplated by Treas Reg §1.1014-3(a) is a value that includes the blockage discount. Accordingly, the taxpayer's step-up in basis was limited to the discounted per artwork value.

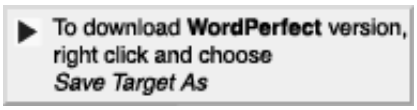
The heirs of the estate appealed the Tax Court's decision to the Ninth Circuit. In *Janis v Commissioner* (9th Cir 2006) 461 F3d 1080, the Ninth Circuit affirmed the Tax Court's decision, holding that the Tax Court did not clearly err in determining the value of the art collection and was correct in concluding that the "duty of consistency" required the parties to use the same value on the income tax returns as agreed to for estate tax purposes. The duty of consistency applies when there is (1) a representation by the taxpayer, (2) on which the IRS relies, and (3) after the statute of limitations runs, the taxpayer changes his previous representation. The Ninth Circuit determined that the heirs had represented that the art collection had a value for estate tax purposes, that the IRS had agreed to that value, and that to allow the heirs to now take the position that the art collection had a different value would "gut the duty of consistency." 461 F3d at 1085. See also *Janis v Commissioner* (2d Cir 2006) 469 F3d 256 (also based on appeal from *Conrad Janis,* TC Memo 2004-117, but because heirs resided in different circuits, appeals went to different courts even though consolidated in trial court; Second Circuit reached same result as Ninth Circuit but did not rely on duty of consistency).

© The Regents of the University of California

VII. FORMS

§7.62 A. Form: Letter Requiring Information From Charity Before Contribution





7.62-1 Letter requiring information from charity before contribution

_ _[*Name of charity*]_ _

_ _[*Address*]_ _

Dear _ _[*name of charity*]_ _ :

I am considering making a contribution to you of a work of art _ _[*describe briefly*]_ _. Before doing so, I wish to have your counsel's opinion as to (1) whether your operations qualify you as a "public-type organization" within the meaning of §170(b)(1)(A)(i)-(viii) of the Internal Revenue Code, and (2) whether the use to which that work of art will be put by your organization is related to the purpose or function constituting the basis for your exemption under §501 of the Internal Revenue Code. I would also like to know the grounds for your counsel's opinion.

Date: _ _ _ _ _ _

Very truly yours,
__[*Signature of donor*]__
_ _[*Typed name*]_ _

© The Regents of the University of California

§7.63 B. Form: Deed of Gift of Entire Interest

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

7.63-1 Deed of gift of entire interest

I, _ _[*name*]_ _, residing at _ _[*address*]_ _, being the absolute owner of the original oil painting called _ _[*specify*]_ _, painted by the artist _ _[*name*]_ _, and dated _ _[*date*]_ _, do hereby give, assign, and transfer over to the _ _[*name of museum*]_ _ of _ _[*name of city and state*]_ _ all of my right, title, and interest in and to the painting, including any copyright interest, if any, absolutely and forever. It is my intention that this transfer of the above-described painting shall constitute a gift of the same by me to the _ _[*name of museum*]_ _, and that the oil painting called _ _[*name*]_ _ shall be displayed, from time to time, as part of the _ _[*name of museum*]_ _'s regular collection.

Date: _ _ _ _ _ _ __[*Signature of donor*]__
_ _[*Typed name*]_ _

ACKNOWLEDGMENT:

State of California)
County of _ _[*name of county*]_ _ **)**
)
)
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

The above-described gift is accepted by me as _ _[*state title*]_ _ **on behalf of the** _ _[*name of museum*]_ _**, of** _ _[*name of city and state*]_ _**, on** _ _[*date*]_ _**, and we agree to acknowledge our acceptance of the gift on IRS Form 8283.**

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

ACKNOWLEDGMENT:

)

State of California)
County of _ _[*name of county*]_ _)
)
)
_____)

On _ _[*date*]_ _ before me, _ _[*name and title of officer*]_ _, personally appeared _ _[*name(s)*]_ _, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

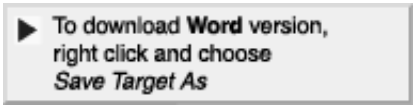
WITNESS my hand and official seal:

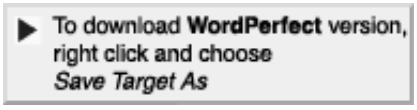
__[*Signature of officer*]__ [*Officer's seal*]

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.64 C. Form: Deed of Gift of Entire Interest (Several Items; Specific Conditions)

§7.64 C. Form: Deed of Gift of Entire Interest (Several Items; Specific Conditions)





7.64-1 Deed of gift of entire interest (several items; specific conditions)

WHEREAS, I, _ _[*name*]_ _, am the owner of the following paintings:

Title	**Description**	**Artist**
1._____	**_____**	**_____**
2._____	**_____**	**_____**

and

WHEREAS, I, _ _[*name*]_ _, desire to give these paintings to _ _[*name of university*]_ _ on the terms and conditions hereinafter set forth;

NOW, THEREFORE, I, _ _[*name*]_ _, give, grant, convey, and confirm to _ _[*name of university*]_ _ all of my right, title, and interest in and to these paintings, including any copyright interest, if any, on the condition that the paintings be made generally available by _ _[*name of university*]_ _ for inspection by the general public at such time and under such regulations and on such conditions as _ _[*name of university*]_ _ may reasonably impose and be utilized by _ _[*name of university*]_ _ as a part of its program for educating its students and on the further condition that each painting be identified as being a part of the _ _[*name*]_ _ Collection by a suitable inscription or plaque.

Date: _ _ _ _ _ _ __[*Signature of donor*]__
_ _[*Typed name*]_ _

ACKNOWLEDGMENT:

State of California)
County of _ _[*name of county*]_ _ **)**
)
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

The above-described gift is accepted by me as _ _[*state title*]_ _ **on behalf of the** _ _[*name of university*]_ _ **on** _ _[*date*]_ _**, and we agree to acknowledge our acceptance of the gift on IRS Form 8283.**

Date: _ _ _ _ _ _

_ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

ACKNOWLEDGMENT:

State of California)
County of _ _[*name of county*]_ _ **)**

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.65 D. Form: Deed of Gift of Fractional Interest

§7.65 D. Form: Deed of Gift of Fractional Interest

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

WARNING: This form should not be used without an understanding of the negative aspects of fractional gifts discussed in §7.28.

7.65-1 Deed of gift of one-fourth interest

I, _ _[*name*]_ _, of _ _[*name of city and state*]_ _, am the owner of the painting hereinafter described. I desire to give to the _ _[*name of museum*]_ _ ("the Museum"), of _ _[*name of city and state*]_ _, an undivided _ _[*e.g., one-fourth*]_ _ interest in the painting. To carry out my purpose and vest immediately in the Museum title and ownership in an undivided _ _[*e.g., one-fourth*]_ _ interest in the painting, I do hereby give, assign, transfer, and deliver to the Museum an undivided _ _[*e.g., one-fourth*]_ _ interest in the painting, including any copyright interest, if any, which is described as follows: _ _[*Describe*]_ _, by _ _[*name of artist*]_ _, dated _ _[*date*]_ _.

It is my purpose to vest in the Museum absolute ownership of an undivided _ _[*e.g., one-fourth*]_ _ interest in the painting at this time, it being understood that the Museum shall have rights of possession, dominion, and control of the painting for the number of months during each 12-month period that the Museum's interest bears to the entire interest. The Museum will have the sole discretion to decide the months during which it will exercise its rights.

Date: _ _ _ _ _ _ __[*Signature of donor*]__
_ _[*Typed name*]_ _

ACKNOWLEDGMENT:

State of California)
County of _ _[*name of county*]_ _ **)**
)
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

The above-described gift is accepted by me as _ _[*state title*]_ _ **on behalf of the** _ _[*name of museum*]_ _**, of** _ _[*name of city and state*]_ _**, on** _ _[*date*]_ _**, and we agree to acknowledge our acceptance of the gift on IRS Form 8283.**

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _,
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

ACKNOWLEDGMENT:

State of California)
County of _ _[*name of county*]_ _ **)**
)
)
)
_____)

On _ _[*date*]_ _ **before me,** _ _[*name and title of officer*]_ _**, personally appeared** _ _[*name(s)*]_ _**, who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.**

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal:

__[*Signature of officer*]__ [*Officer's seal*]

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/7 Charitable Giving of Works of Art and Other Collectibles: Planning, Taxation, Valuation/§7.66 E. Form: Specific Gift of Work of Art

§7.66 E. Form: Specific Gift of Work of Art

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

7.66-1 Specific gift of work of art

_ _[*Article number*]_ _. **I give to the** _ _[*name of museum*]_ _**, in** _ _[*name of city and state*]_ _**, the items described below, including any copyright interest, if any:**

1. Oil painting titled _ _[*name*]_ _**, by** _ _[*name*]_ _**, dated** _ _[*date*]_ _**.**

2. _ _[*Specify.*]_ _

PROVIDED, HOWEVER, if at the time of my death the _ _[*name of museum*]_ _ **is not an organization described in §2055(a) of the Internal Revenue Code, or corresponding provisions of any subsequent Federal tax laws, I give said items to such other organization as is described in §2055(a) that is designated by my Executor.**

© The Regents of the University of California

§7.67 F. Form: Checklist for Qualified Appraisal

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

7.67-1 Checklist for qualified appraisal

Information Required to Be Contained in an Appraisal of Tangible Personal Property Being Contributed to Charity for Which a Deduction Will Be Claimed for Federal Income Tax Purposes

The following information is required under Reg §1.170A-13(b)(2)(ii):

1. DESCRIPTION OF THE PROPERTY—in sufficient detail for a person who is not generally familiar with the type of property to ascertain that the property that was appraised is the property that was—or will be—contributed.

Description should include dimensions, color, materials used, and, if known, date of creation, maker, location of origin, and whatever other factual details would be helpful.

2. PHYSICAL CONDITION OF THE PROPERTY—the appraisal should note any repairs, defects, worn elements, fading, etc.

3. DATE—OR EXPECTED DATE—OF CONTRIBUTION TO CHARITY.

4. DATE OR DATES ON WHICH THE PROPERTY WAS VALUED BY THE APPRAISER—note that the appraisal cannot be prepared more than 60 days before the actual date of contribution of the appraised property.

5. METHOD OF VALUATION—used to determine the fair market value, such as comparable sales approach or replacement-cost-less-depreciation approach.

6. SPECIFIC BASIS FOR VALUATION—if any, such as specific comparable sales transactions.

7. TERMS OF ANY AGREEMENT—or understanding between the donor and the donee charity relating to the use, sale or other disposition of the property. If none, the appraisal should so state, or if there are, the appraisal should explain.

8. FEE ARRANGEMENT BETWEEN DONOR AND APPRAISER—fees based on a percentage of the value will render the appraisal invalid for income tax contribution purposes.

9. QUALIFICATIONS OF THE APPRAISER—including background, experience, education and membership, if any, in professional appraiser association. There should be included, in addition, specific examples of qualifications by way of experience or background to appraiser the particular items which are the subject of the appraisal.

10. FAIR MARKET VALUE—the appraised value of the property which is the subject of the appraisal as of the date (or expected date) of contribution.

11. PURPOSE OF APPRAISAL—a statement that the appraisal was prepared for federal income tax purposes.

12. SIGNATURE OF APPRAISER ON THE APPRAISAL—the name, address, and taxpayer identification number of the appraiser must be on the appraisal.

© The Regents of the University of California

8

Copyrights, Patents, and Trademarks

Peter R. Afrasiabi
Timothy J. Kay

I. INTRODUCTION §8.1

II. COPYRIGHTS

A. Brief History of Copyright Law

1. England and the Printing Press §8.2

2. Copyrights in United States §8.3

3. International Copyrights §8.4

B. What Is Protected by Copyright

1. Original Works of Authorship §8.5

2. Rights Protected in Original Works §8.6

C. Two Types of Copyrights

1. Individual Authors §8.7

2. Works for Hire §8.8

D. Copyright Duration §8.9

1. Pre-1978 Works §8.10

2. Works Created or Published On or After January 1, 1978 §8.11

E. Transfers of Copyright Ownership §8.12

F. Copyrights and California Community Property Laws §8.13

G. Copyright Renewal and Termination Rights §8.14

1. Renewal Rights §8.15

2. Termination Rights

a. Recapture of Extended Renewal Term for Pre-1978 Transfers (17 USC §304(c)) §8.15A

(1) Types of Grants Subject to Termination Provisions §8.15B

(2) Who May Terminate §8.15C

(3) When Termination of Grant May Occur §8.15D

(4) Any Agreement to the Contrary Is Void §8.15E

b. Termination of Transfers Under 17 USC §203(a) §8.16

(1) Who May Terminate §8.16A

(2) When Assignment May Be Terminated §8.16B

(3) "Otherwise Than By Will" Exception §8.16C

3. How Reversion of Rights Through Copyright Termination Is Exercised §8.17

H. Tax Issues of Copyrights

1. Income Tax Character of Copyrights §8.18

2. Charitable Contributions of Copyright §8.19

3. Gift and Estate Tax Issues §8.20

4. Marital Deduction Issues §8.21

5. Valuation Issues §8.22

6. Liquidity §8.23

III. PATENTS §8.24

A. Brief History of U.S. Patent Law §8.25

B. Grant of Patent by Patent and Trademark Office

1. Application §8.26

2. What Is Protected by Patent Grant §8.27

3. Patent Duration §8.28

4. Ownership §8.29

C. Tax Issues of Patents

1. Income Tax Character of Patents §8.30

2. Charitable Contributions of Patents §8.31

3. Gift and Estate Tax Issues of Patents §8.32

4. Liquidity §8.33

IV. TRADEMARKS §8.33A

A. Brief History of Trademark Law §8.33B

B. Establishing and Maintaining Trademark Rights

1. State Protection §8.33C

2. Federal Protection §8.33D

3. Trademarkability §8.33E

4. Maintenance §8.33F

C. Trademark Issues for Estate Planners

1. Family Businesses: Sole Proprietorships or Closely Held Corporations §8.33G

2. Personal Name Marks §8.33H

3. Trademark Assignments in Wills or Trusts §8.33I

V. CALIFORNIA STATUTORY RIGHTS

A. State Law Bonus to Artist for Subsequent Sales of Fine Art §8.34

B. Publicity Rights §8.35

© The Regents of the University of California

§8.1 I. INTRODUCTION

Copyrights, patents, and trademarks are assets that are not common to the vast majority of estates that the typical estate planner may plan or administer. A lawyer representing a client with significant interests in copyrights, patents, or trademarks, or with royalties based on such interests, needs to spend the time to become familiar with the issues that may relate to that particular client.

This chapter is not intended to provide an exhaustive review of the laws affecting intellectual property. Obviously, a number of different multivolume treatises, books, and articles explore these issues in depth. Instead, the chapter covers some basic intellectual property issues and income and estate tax issues, as well as estate planning ideas that will be of interest to the estate planner.

Patents and copyrights are monopoly property rights granted for a limited period of time as an incentive to produce new and valuable work. They also share common characteristics that are relevant to the estate planner, but they differ in other important ways. Copyrights are less favored from the income tax and transfer tax perspective. Furthermore, they have more complicated ownership rights issues. However, because copyrights now last for the life of an author plus 70 years, copyrights and/or royalties will almost inevitably make up a large part of an author's estate.

Copyrights are discussed in §§8.2-8.23; patents are covered in §§8.24-8.33; trademarks are covered in §§8.33A-8.33I; and specific California statutory rights are discussed in §§8.34-8.35.

© The Regents of the University of California

II. COPYRIGHTS

A. Brief History of Copyright Law

§8.2 1. England and the Printing Press

Before the invention of the printing press, copies of books and manuscripts were made by hand. The process was so labor-intensive that there was no perceived need for copyright protection.

After the printing press began to be used in England, the Crown granted a single guild, the Stationer's Company, the sole right to print books and pamphlets, beginning in 1557. On the basis of this monopoly granted by the Crown, the publisher owned all the rights now thought of as copyrights. Copyright law since then has been in part an evolving response to technological changes.

The Licensing Act of 1662 provided that the Stationer's Company should only publish works authorized by the Crown. Publication of unlicensed works violated the Licensing Act and subjected the unauthorized publisher to criminal penalties. In this way, the monopoly of the Stationer's Company was strengthened, and its dependence on the Crown increased. Because the Stationer's Company had monopoly bargaining power, authors typically received nominal fees for their works. For example, John Milton received £10 for *Paradise Lost* and William Shakespeare received £2 per play.

In 1709, the English Parliament changed the legal relationship of authors and publishers by passing the Statute of Anne. This act maintained monopoly rights in the Stationer's Company for previously acquired works, but it also enacted the first copyright protection afforded to authors, dividing protection into two 14-year terms. This two-term regime, as opposed to one 28-year term, was created specifically to allow an author to assign his or her work and then rebargain for the assignment of the copyright for the second term. Copyright laws in the United States were based on the Statute of Anne; American law imported its structure allowing an author to rebargain for the value of a previously assigned copyright.

© The Regents of the University of California

§8.3 2. Copyrights in United States

Congressional authority to establish copyrights is found in the Constitution of the United States. "The Congress shall have Power … to promote the Progress of Science and the useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries." US Const art I, §8, cl 8. In 1790, Congress exercised its constitutional authority to establish the first copyright law in the United States, granting a 14-year copyright for books, maps, and charts and a renewal term of 14 years. Ch 15, 1 Stat 124 (May 31, 1790) (hereafter the Copyright Act). For the next 120 years, Congress revised and expanded the law of copyright. The Copyright Act of 1909 (Ch 320, 35 Stat 1075 (Mar. 4, 1909)) (hereafter the 1909 Act) continued the renewal system of two terms, now 28 years each. This dual-term system was designed to protect authors "against unremunerative transfers" that resulted from "the unequal bargaining power of authors," due "in part [to] the impossibility of determining a work's prior value until it has been exploited." H Rep No. 2222, 60th Cong, 2d Sess (1909) at 124. But the Supreme Court interpreted the 1909 Act to allow an assignment of "all interests" to include the renewal term, eliminating an author's ability to rebargain for the renewal term if in the intervening years the work had become valuable. *Fred Fisher Music Co. v M. Witmark & Sons* (1943) 318 US 643, 658, 87 L Ed 1055, 63 S Ct 773.

To remedy this deficiency and to begin to harmonize United States copyright law with most foreign copyright law, Congress revised the 1909 Act with the Copyright Act of 1976 (Pub L 94-553, 90 Stat 2541) (hereafter the 1976 Act), effective January 1, 1978. The 1976 Act revised and expanded copyright protection in the United States in several important ways, replacing the two-term copyright structure with a copyright term of the life of the author plus 50 years. The 1976 Act also extended the life of a 1909 Act copyrighted work by 19 years, for a total of 75 years (28+28+19), and made clear that any assignment of the new 19-year renewal term was void as a matter of federal law. Therefore, different rules apply to copyrights in existence before 1978 and those coming into existence thereafter.

A significant benefit was accorded copyright holders by the Sonny Bono Copyright Term Extension Act (Pub L 105-298, 112 Stat 2827) (hereafter the 1998 Act), which extended the life of existing 1909 Act copyrights by 20 years, for a total of 95 years, and increased the life of a copyright for works created after January 1, 1978, to life plus 70 years. This statute earned its nickname, the "Mickey Mouse Copyright Act," because it had the practical effect of extending the copyright of the Walt Disney Company in Mickey Mouse, Donald Duck, and Goofy, which would have begun entering the public domain in 2003. Over an enormous amount of controversy regarding the phrase "securing for limited times," the United States Supreme Court upheld the constitutionality of extending the existing copyright terms in *Eldred v Ashcroft* (2003) 537 US 186, 154 L Ed 2d 683, 123 S Ct 769.

© The Regents of the University of California

§8.4 3. International Copyrights

A common approach to copyright ownership and copyright terms was established in Europe with the Berne Convention for the Protection of Literary and Artistic Works of 1886 (usually referred to as the Berne Convention). In a nutshell, each signatory country agrees to provide the same legal treatment to the citizens and residents of other Berne Convention signatories as that country provides to its own citizens.

The common copyright term among most European countries has been the life of the author plus 70 years.

The United States did not formally subscribe to the Berne Convention until 1989. Berne Convention Implementation Act of 1988 (Pub L 100-568, 102 Stat 2853). Additional conforming changes were made to United States copyright law in the Visual Artists Rights Act of 1990 (VARA) (17 USC §106A) and the Uruguay Round Agreements Act of 1994 (Pub L 103-465, 108 Stat 4809). VARA was important legislation because it was the first statutory recognition of moral rights (albeit limited) for artists, further aligning United States law with the rest of the world where moral or natural rights concepts generally undergird copyright law.

© The Regents of the University of California

B. What Is Protected by Copyright

§8.5 1. Original Works of Authorship

Title 17 USC §102(a) states:

Copyright protection, subsists, in accordance with this title, in original works of authorship fixed in any tangible medium of expression.... Works of authorship include the following categories: (1) literary works; (2) musical works, including any accompanying words; (3) dramatic works, including any accompanying music; (4) pantomimes and choreographic works; (5) pictorial, graphic, and sculptural works; (6) motion pictures and other audiovisual works; (7) sound recordings; and (8) architectural works.

© The Regents of the University of California

§8.6 2. Rights Protected in Original Works

The following rights are protected in original works fixed in a tangible medium of expression:

- Right to reproduce the copyrighted work (17 USC §106(1));
- Right to prepare derivative works (17 USC §106(2));
- Right to distribute copies to the public (17 USC §106(3));
- Right to perform the works or display the works in public or by digital audio transmission (17 USC §106(4)-(6)); and
- Right to attribution and integrity for certain works of visual art (17 USC §106A).

© The Regents of the University of California

C. Two Types of Copyrights

§8.7 1. Individual Authors

Copyright in an original work vests initially in the author or authors of the work. 17 USC §201(a). The authors of a joint work are co-owners of the copyright. 17 USC §201(a). The co-owners hold equal undivided interests in the copyright as cotenants, regardless of differing contributions by the co-authors. *Erickson v Trinity Theatre, Inc.* (7th Cir 1994) 13 F3d 1061; *Childress v Taylor* (2d Cir 1991) 945 F2d 500; *Pye v Mitchell* (9th Cir 1978) 574 F2d 476.

© The Regents of the University of California

§8.8 2. Works for Hire

Different rules may apply to works made by an employee or an independent contractor. A work prepared by an employee within the scope of his or her employment is defined as a work for hire. 17 USC §101. A work prepared by an independent contractor is a work for hire if and only if it is "specially ordered or commissioned" for use as any of the following (17 USC §101):

- A contribution to a collective work;
- A part of a motion picture or other audiovisual work;
- A translation;
- A supplementary work;
- A compilation;
- An instructional text;
- A test;
- Answer material for a test; or
- An atlas.

The parties also must expressly agree in a written agreement that the work is a work for hire.

If a work is considered a work for hire, in the absence of a written agreement to the contrary, "the employer or other person for whom the work was prepared" is the initial copyright owner of a work for hire. 17 USC §201(b); *May v Morganelli-Heumann & Assocs.* (9th Cir 1980) 618 F2d 1363; *Moran v London Records, Ltd.* (ND Ill 1986) 642 F Supp 1023, aff'd (7th Cir 1987) 827 F2d 180. As noted in §8.11, the copyright term of a work for hire differs from that initially vested in one or more authors.

© The Regents of the University of California

§8.9 D. Copyright Duration

After taking into account the effect of the Sonny Bono Copyright Term Extension Act of 1998 in extending the terms of all existing copyrights by 20 years, what follows in §§8.10-8.11 is a summary of the duration of various copyrights in existence today.

© The Regents of the University of California

§8.10 1. Pre-1978 Works

Under earlier laws, copyright terms were initially granted for 28 years and were renewable for an additional 28 years. The 1976 Act extended those copyright terms by 19 years, for a total of 75 years from date of publication. Pub L 94-553, §304, 90 Stat 2541. Failure to renew a copyright at the appropriate time caused the copyrighted material to fall into the public domain. In 1992, Congress provided for the automatic renewal of pre-1978 copyrights. Copyright Renewal Act of 1992 (Pub L 102-307, §102, 106 Stat 264). This eliminated the requirement that a copyright holder file an application for renewal, although it is advantageous for the copyright holder to do so.

The Sonny Bono Copyright Term Extension Act extended the maximum 75-year term an additional 20 years, for a total of 95 years from date of publication.

© The Regents of the University of California

§8.11 2. Works Created or Published On or After January 1, 1978

The 1976 Act changed the measurement of the duration of a copyright in an original work created by one or more individuals from a strict term of years to one based on a life plus 50 years. Pub L 94-553, §302(a), 90 Stat 2541. Instead of looking to the date of publication to ascertain when a work secured copyright protection, under the 1976 Act, the copyright exists at the moment of creation whether or not the work is published or registered with the copyright office, and the copyright lasts for the life of the author plus a term of years. Following the European model, the general rule in the United States (after the Sonny Bono Copyright Term Extension Act) is that a copyright term will last for the life of the author plus 70 years following his or her death. 17 USC §302(a). See §§8.3-8.4. In the case of joint works, the term of years begins to run following the death of the surviving author. 17 USC §302(b).

Works for hire are subject to different copyright terms because the original owner may not be a natural person. Instead, the term of the copyright will run until (1) the date 95 years from the date of publication or (2) 120 years from the creation of the work, whichever expires first. 17 USC §302(c). As long as the work is actually published within 25 years of its creation, the 95-year term will be applicable.

© The Regents of the University of California

§8.12 E. Transfers of Copyright Ownership

Copyrights are items of intangible personal property. Ownership of a copyright may be transferred in whole or in part, by conveyance or operation of law, and at death by will or intestate succession. 17 USC §201(d)(1).

Interests in copyrights may be divided in many ways. This allows the corresponding rights of these interests to be transferred to different parties. 17 USC §201(d)(2). The simplest transfer to understand is a complete assignment of all the copyright holder's rights in a given work. Such an assignment may transfer to the assignee, *e.g.,* the rights to publish the work, create derivative works, or grant licenses to others. The assignment must be in writing and signed by the copyright owner or the owner's agent. 17 USC §204(a). Under certain circumstances, the author or his or her federally defined heirs may terminate an absolute assignment unilaterally. For discussion of these valuable termination rights, see §§8.14-8.17.

An alternative to an absolute assignment is an exclusive license granting the licensee certain rights to exploit the copyrighted work. Such a license could be limited in a number of ways, *e.g.,* by geography, a term of years, or a particular subject matter. Thus, an author could grant a publisher the exclusive rights to publish a work in hard cover in North America. In this case, the author would retain the right to license the soft cover rights in North America to another, the right to all other publishing rights in the rest of the world, and the right to make derivative works (such as a motion picture based on the novel).

Another alternative is to grant a nonexclusive license. With a nonexclusive license, the copyright owner retains the right to grant additional nonexclusive licenses to other persons under the same conditions.

If the original copyrighted work was created by an employee as a work for hire, no assignment is required to transfer ownership of the copyright to the employer. The employer is presumed to be the owner of the copyright as a work made for hire absent a written agreement to the contrary. See §8.8.

© The Regents of the University of California

§8.13 F. Copyrights and California Community Property Laws

Copyrights created by an author during a marriage are community property in California. *Marriage of Worth* (1987) 195 CA3d 768, 241 CR 135. The Fifth Circuit Court of Appeals, interpreting Louisiana community property law, followed the California Court of Appeal's general reasoning in *Worth* to hold that a copyright becomes community property of the marriage, but with certain restrictions dictated by the Copyright Act. *Rodrigue v Rodrigue* (5th Cir 2000) 218 F3d 432, cert denied (2001) 532 US 905. Other community property states have not yet weighed in on the matter. There are also serious preemption-related issues that may be interpreted differently by the courts, as these issues have been addressed in only a handful of cases.

California's rules regarding the management of community property apply to the management of community property copyrights during the marriage. See Fam C §1100. Either spouse may exercise control over and management of the community personal property (including copyrights, which are considered intangible personal property) with absolute power of disposition of the property for fair and reasonable value. Fam C §1100(a).

Community property copyrights are divisible at death or in marital dissolution proceedings. *Marriage of Worth, supra*. A copyright assigned to the spouse who did not do the writing or other composition will be treated as if it were owned by the original author, not by an assignee. *Marriage of Worth, supra*.

The parties to the marriage may, of course, alter their respective rights in what would otherwise be community property copyrights by a binding premarital agreement or status of property agreement during the marriage.

© The Regents of the University of California

§8.14 G. Copyright Renewal and Termination Rights

Congress has included mechanisms in the United States copyright law that are intended to permit an author or specified surviving family members of an author to recover a copyright that has previously been absolutely assigned or licensed to others:

- Renewal rights for the last 67 years of existing copyrights, "the first term of which is subsisting on January 1, 1978" (17 USC §304(a)) (see §8.15);
- Termination rights for the extended renewal terms created by the 1976 Act and the 1998 Act, specifically the additional 19 and 20 years, respectively (39 years total), for any work that was in its first or renewal term on January 1, 1978 (17 USC §304(c)) (see §8.15); and
- Termination rights for copyrights granted on or after January 1, 1978 (17 USC §203) (see §8.16).

Termination rights generally impact trusts and estates attorneys in two scenarios:

(1) If a client assigned a copyright, that assignment may be terminated by the creator or his or her statutory heirs so that the copyright may be marshaled into the estate; and

(2) If a client is a copyright holder with specific goals for the disposition of his or her copyrights, federal law restricts the ability to effect that intent.

Federal law grants the creator's statutory heirs the right to terminate any copyright transfer in certain circumstances even if the copyright holder's testamentary intent is to divest those heirs of any rights. See discussion in §§8.15-8.16.

© The Regents of the University of California

§8.15 1. Renewal Rights

Renewal rights issues have diminished in importance because they only apply to copyrights issued before 1978 and arise in the 28th year of the copyright. Generally, under current law, the last date that pre-1978 renewal rights could have been applied for was December 31, 2005, so this is no longer a planning issue. However, the estate planner still needs to be aware that a pre-1978 work other than a work for hire may be terminated by the author at 56 years from the initial publication, and if it had not been terminated previously, at 75 years from the initial publication, as provided under the Sonny Bono Copyright Term Extension Act. 17 USC §304(c)-(d). For detailed discussion, see *Milne v Stephen Slesinger, Inc.* (9th Cir 2005) 430 F3d 1036; *Penguin Group (USA) Inc. v Steinbeck* (2d Cir 2008) 537 F3d 193. For further discussion of termination rights, see §§8.15A-8.16C.

© The Regents of the University of California

2. Termination Rights

§8.15A a. Recapture of Extended Renewal Term for Pre-1978 Transfers (17 USC §304(c))

This category of works and renewals currently affects trusts and estates attorneys because it involves any pre-1978 transfer of a work for which copyright renewal periods are current. Generally, any copyrighted work in its first or renewal term on January 1, 1978, that was previously assigned is potentially subject to termination and recapture of the extended renewal term under 17 USC §304(c).

© The Regents of the University of California

§8.15B (1) Types of Grants Subject to Termination Provisions

Any "transfer" of a copyright interest by the author or the statutorily defined class of heirs is a grant that may be terminated. 17 USC §304(c). This includes the assignment of a copyright or the grant of a nonexclusive license of the copyright or any of the rights comprised in a copyright. It includes a mortgage or other hypothecation of a copyright interest. In short, any conveyance or alienation of a copyright interest is a grant that may be subject to the termination provisions. 17 USC §101.

There are exceptions to what constitutes a grant that is subject to termination. The main exception of interest to trusts and estates lawyers is that the statutory heirs do not have the right to undo a pre-1978 transfer of copyright by will. However, a widow, child, or grandchild of a content creator who transferred a copyright through a trust or an instrument other than a will may be able to undo the transfer and secure back the renewal period (the last 39 years or even the last 20 years if the opportunity to terminate was missed) even if that was inconsistent with the creator's testamentary intent as reflected in the trust documents.

AUTHOR'S ADVICE: Because the statute refers specifically to a will, it is not clear that the same termination right provisions would apply if the author employed a revocable trust as a will substitute. See 17 USC §203(a). The statute does not define "will" to include a "trust." Thus, if an author wishes to convey his or her interest in a copyright to a third person and preclude the statutory heirs from undoing that transfer through these termination of transfer provisions, the only clear mechanism is to effect that transfer of the copyrights through a will.

Another exception is a "work for hire." Analysis of the applicability of this exception is a complicated endeavor. For example, in *Marvel Characters, Inc. v Simon* (2d Cir 2002) 310 F3d 280, Simon assigned his copyrights to Marvel. Many years later, the parties settled litigation with an agreement that retroactively deemed the originally assigned copyrights to be "works for hire." The court held that (1) this after-the-fact agreement that sought to exempt the work from copyright termination provisions was invalid and (2) whether a work was "for hire" turned on the facts and circumstances, not how the parties subsequently tried to characterize it. 310 F3d at 292.

© The Regents of the University of California

§8.15C (2) Who May Terminate

For copyrights that were assigned or transferred before January 1, 1978, federal law dictates a hierarchy of people who may terminate an assignment or transfer and secure back the extended renewal term of 39 years. Any pre-1978 transfer of a copyright, unless the transfer was in a will (or the work was a work for hire), may be terminated by the following (17 USC §304(c)(1)-(2)):

- The author;
- The author's widow or widower unless there are children or grandchildren, in which case the widow or widower owns 50 percent;
- The surviving children or grandchildren (who own 50 percent on a per stirpes basis); or
- If the author's widow or widower, children, and grandchildren are not living, the author's executor, administrator, personal representative, or trustee.

"Widow or widower" is defined as "surviving spouse under the law of the author's domicile at the time of his or her death." 17 USC §101. Whether a domestic partner under a given state's legal regime is a "spouse" under federal law would be determined by each state's law. California courts have held that registered domestic partners "are the equivalent of spouses" for purposes of California's Unruh Civil Rights Act (CC §51) (see *Koebke v Bernardo Heights Country Club* (2005) 36 C4th 824, 831, 31 CR3d 565; *In re Domestic Partnership of Ellis* (2008) 162 CA4th 1000, 1008, 76 CR3d 401 (applying equitable putative spouse doctrine to registered domestic partners)), so strong arguments support the conclusion that a registered domestic partner in California should get the benefit of the federal statute's grant.

AUTHOR'S ADVICE: Trusts and estates attorneys need to be aware of these issues for two classes of clients: (1) those who assigned a copyright and may get that copyright back (this class includes widows and heirs who may own the right to terminate even though they did not create or assign the original work) and (2) those who own copyrights and have specific testamentary goals that may not include the federally defined heirs.

© The Regents of the University of California

§8.15D (3) When Termination of Grant May Occur

The grant may be terminated at any time during a 5-year period beginning at the end of 56 years from the date copyright was originally secured or beginning on January 1, 1978, whichever is later. 17 USC §304(c)(3). Advance written notice to appropriate persons and entities is required, specifying the date of termination within that 5-year window. The notice of intent to terminate must be served between 2 and 10 years before the specified date of termination. 17 USC §304(c)(4). If the first renewal window is missed, the statutorily defined class may still secure the last 20 years of the extended renewal term if termination is effected during a 5-year period beginning at the end of 75 years from the date copyright was originally secured. 17 USC §304(d).

Siegel v Warner Bros. Entertainment, Inc. (CD Cal 2008) 542 F Supp 2d 1098 exemplifies this procedure and its value to widows and heirs. In 1938, the creators assigned their rights in Superman for $130.00 to DC Comics. In 1966 (after the first 28-year term), they were unable to rebargain because of the intervening decision in *Fred Fisher Music Co. v M. Witmark & Sons* (1943) 318 US 643, 658, 87 L Ed 1055, 63 S Ct 773 (see §8.3), which held that general assignments of all interests covered the renewal term. In the 5-year window after the second 28-year term expired, the creators' heirs served notice of termination on Warner Bros., the successor to DC Comics. After years of litigation, in 2008 the heirs secured back the rights to Superman. Any future Superman movies, TV shows, etc., are now controlled by the heirs. Warner Bros. retains the right to utilize preexisting derivative works it made during the period of the license.

© The Regents of the University of California

§8.15E (4) Any Agreement to the Contrary Is Void

This right to terminate trumps "any agreement to the contrary," including an author's agreement to make a will or to make a future grant of the renewal period. 17 USC §304(c)(5). This provision was added in the 1976 Act in response to the decision in *Fred Fisher Music Co. v M. Witmark & Sons* (1943) 318 US 643, 658, 87 L Ed 1055, 63 S Ct 773, that an advance assignment of renewal rights was enforceable. Transfers by wills and works for hire are exempted from the termination structure. 17 USC §304(c)(5). See §8.15B. However, other agreements are generally not exempted and would be deemed invalid agreements to the contrary.

Whether a given structure is a legitimate structure or an unlawful agreement to the contrary that eviscerates the rights of the class to secure the renewal term is a complicated question with conflicting judicial opinions. The governing federal policy is to not allow publishing companies to divest the statutory class, so properly understood, most structures that do this are probably infirm.

Federal cases interpreting "agreement to the contrary" have reached inconsistent and conflicting results. For example, in *Classic Media, Inc. v Mewborn* (9th Cir 2008) 532 F3d 978, the author secured the copyright in 1940. The widow and heirs renewed the copyright in 1968 and then licensed it to a publisher. In the late 1990s, the author's daughter sought to terminate the grant. The publisher argued that an intervening 1978 agreement between it and the daughter effected a waiver of her termination rights. The Ninth Circuit held that the 1978 agreement was invalid; the daughter had no termination rights to assign in 1978 because the copyright termination notice period did not begin until, at the earliest, 10 years before the expiration of the 56-year period in 1996. See also *Marvel Characters, Inc. v Simon* (2d Cir 2002) 310 F3d 280 (after-the-fact attempt to redefine work as work for hire was invalid agreement to the contrary and could not thwart author's termination rights).

The Second Circuit reached a conclusion seemingly at odds with the statute in *Penguin Group (USA) Inc. v Steinbeck* (2d Cir 2008) 537 F3d 193, which addressed a 1938 assignment by John Steinbeck to Penguin Publishers. Steinbeck died in 1968, and in 1994, the 56th year from the assignment, his widow entered a publishing agreement with Penguin that purported to rescind the 1938 agreement and create new royalty terms. The widow was on poor terms with Steinbeck's children; in 1994, each camp had 50 percent of the termination right, so neither camp could terminate because they did not have more than one-half of the termination right. When the widow died in 2003, the Steinbeck descendants, who now owned 100 percent of the termination right (the widow could not will her right to terminate or her contingent possible termination right), served termination notices to secure the last 20-year renewal term. Because the 1994 agreement did not deprive the Steinbeck descendents of any rights they could have exercised, the Second Circuit held that the 1994 agreement was not invalid as an "agreement to the contrary," even though the agreement had the effect of eliminating a termination right that the legislature did not add until 1998. Consequently, the termination notice filed by Steinbeck's descendants was invalid because the 1994 agreement superseded the 1938 agreement and there was no longer a pre-1978 agreement to terminate.

NOTE: The author believes this decision is fatally at odds with the federal statutory scheme and policy because it allows the statutory class of heirs to be thwarted from ever terminating because of a purported "rescission" of the original 1938 agreement by Steinbeck's successor to the contract. See 3 Nimmer on Copyright §11.07 (2009), in which Nimmer, in an amicus brief in support of the granting of certiorari in the Steinbeck case, argues that the "Second Circuit has eviscerated that clear Congressional command [that termination of a grant may be effected notwithstanding any agreement to the contrary] by enabling a grantee to renegotiate the terms of the grant so as to frustrate recapture by the author's family." Although certiorari was denied in *Steinbeck v Penguin Group (USA) Inc.* (2009) ___ US ___, 173 L Ed 2d 1326, 129 S Ct 238, the author expects it will eventually be overruled.

There is an exception to the "agreement to the contrary" provision. When the original grantee and grantor, or their successors, renegotiate the terms of the original agreement during the termination window, the renegotiated agreement is not an "agreement to the contrary." See *Milne v Stephen Slesinger, Inc.* (9th Cir 2005) 430 F3d 1036.

© The Regents of the University of California

§8.16 b. Termination of Transfers Under 17 USC §203(a)

For transfers that occur on or after January 1, 1978, the 1976 Act abandoned the renewal system as an (ineffective) protective measure for the families of authors and adopted a termination right of any prior assignment. 17 USC §203(a). Substantively, this right to terminate is similar to the right to secure the extended renewal term for 1909 Act works in that both allow a copyright assignment to be terminated and both allow the same federal class of heirs to secure back the copyright. However, there are some significant differences relevant to the trusts and estates practitioner.

© The Regents of the University of California

§8.16A (1) Who May Terminate

Termination rights are exercisable only by the author, if alive (17 USC §203(a)(1)), or otherwise by the author's surviving spouse, children, and grandchildren. 17 USC §203(a)(2). If there is a surviving spouse but no children or grandchildren, the surviving spouse owns the entire termination right. 17 USC §203(a)(2)(A). If there are both a surviving spouse and children, the spouse owns one-half of the termination right, and the children and any children of a predeceased child own the other one-half per stirpes. 17 USC §203(a)(2)(B)-(C). If the decedent has no surviving spouse, children, or grandchildren, the author's executor, administrator, personal representative, or trustee owns the entire termination right. 17 USC §203(a)(2)(D). If there is more than one author of the copyrighted work, the original authors or their successors holding a majority of the interests may exercise the termination right. 17 USC §203(a)(1).

There is an important difference between pre-1978 and post-1977 assignments. For post-1977 assignments, the statutory class may only terminate an assignment that was made by the author. 17 USC §203(a). In contrast, for pre-1978 assignments, the renewal term may be recovered by the class whether the assignment was made by the original author *or* a successor or heir. 17 USC §304(c). Successors thus have an interest in "rescinding" pre-1978 agreements and entering post-January 1, 1978, agreements, as in *Penguin Group (USA) Inc. v Steinbeck* (2d Cir 2008) 537 F3d 193 (new agreement, in which widow negotiated better bargain, terminated and superseded earlier agreement and made termination notice filed by author's heirs invalid). Termination rights arguably do not attach to the post-1977 agreements, precluding the statutory class from effecting a termination.

© The Regents of the University of California

§8.16B (2) When Assignment May Be Terminated

Any inter vivos transfer of copyright interests made by an author after 1977 may be terminated 35 years after the transfer. Termination of the transfer may take effect at any time during the 5-year period commencing on the 35th anniversary of the initial assignment. 17 USC §203(a)(3). These termination rights will begin to take effect in January 2013 for transfers made in January 1978. However, if the assignment also includes the right of publication of the work, the period begins 35 years from the date of publication of the work under the assignment or 40 years from the date of the assignment's execution, whichever occurs first. 17 USC §203(a)(3).

© The Regents of the University of California

§8.16C (3) "Otherwise Than By Will" Exception

As discussed in §8.15B, an author's transfer of a copyright in a will is an exception to the right to terminate. The statutory class of people who may terminate an author's post-1977 copyright transfer may not do so if the copyright was transferred through a will.

AUTHOR'S ADVICE: The attorney should consider adding some questions to the checklist or intake forms to help identify copyright termination or renewal issues. These questions may include:

- Have you ever created a copyrighted work?
- Have you ever assigned a copyright interest?
- Was your spouse, parent, or grandparent a musician, filmmaker, writer, artist, entertainer, or anyone in the arts field?
- Has your spouse, parent, or grandparent ever created a copyrighted work or assigned a copyright interest?

If there are possible copyright issues, consider advising your client to consult a copyright attorney.

© The Regents of the University of California

§8.17 3. How Reversion of Rights Through Copyright Termination Is Exercised

Termination rights may be exercised in the same manner under 17 USC §203(a) for post-1977 and 17 USC §304(c) for pre-1978 copyright grants. See §8.15D. Among other formalities, the surviving author or his or her protected class must deliver written notice of the exercise of the termination right to the grantees—the current owners of the copyright. 17 USC §§203(a)(4), 304(c)(4). The only difference is when termination rights may be exercised. For pre-1978 grants, see §8.15D. For post-1977 grants, see §8.16B.

In either case, the notice of termination may be served between 2 and 10 years before the specified termination date. The notice must specify a termination date within the appropriate window of time. The person(s) exercising the termination right must do the following (17 USC §§203(a)(4), 304(c)(4); 37 CFR §201.10(c)):

- Provide the grantee or the grantee's successor in title with the notice and specify exactly which assignments for which works are being terminated; and
- Record the written notice in the copyright office.

Ironically, although the 1976 Act was designed to eliminate many of the technical formalities in copyright law that previously had threatened the validity of copyrights, any technical noncompliance or mistake can invalidate a termination attempt. For example, in *Burroughs v Metro-Goldwyn-Mayer, Inc.* (SD NY 1980) 491 F Supp 1320, the court invalidated a termination notice that had failed to provide formal notice to the original grantee's successor, even though the original grantee received the notice.

AUTHOR'S ADVICE: The mechanics of terminating are quite complex. An attorney who has a client who may have an intangible property copyright asset (right to terminate and take back the copyright) should consult with a copyright attorney to ascertain when and exactly how termination of that assignment may be effected.

Assuming all formalities are done correctly, the copyright reverts to the living author or to his or her surviving spouse, children, and grandchildren as of the specified date of termination. The prior assignee loses all right to further exploit the copyright domestically, although preexisting derivative works created during the period of the assignment or license may continue to be exploited. 17 USC §304(c)(6)(A).

© The Regents of the University of California

H. Tax Issues of Copyrights

§8.18 1. Income Tax Character of Copyrights

A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property such as a photograph is generally not a capital asset in the hands of the person whose personal efforts created the property or a transferee whose basis is determined in whole or in part by reference to the creator's basis ("carryover basis"). IRC §1221(a)(3); Reg §1.1221-1(c)(1). Examples of such a transferee include a donee of an interest in the copyright or a partnership or corporation to which the author had transferred the copyright when the donee, partnership, or corporation has a carryover basis in the contributed interest. However, a copyright in the hands of an owner who paid consideration for the copyright is not subject to the same rule.

NOTE: Songwriters can elect capital gains treatment for the sale or exchange of musical compositions or copyrights that occur after December 31, 2006, and before January 1, 2011. IRC §1221(b)(3); Pub L 109-222, 120 Stat 346.

The proceeds of the sale of a copyright by the author or by a transferee with carryover basis will be ordinary income. IRC §1221; Reg §1.1221-1(c)(1). A gratuitous transfer of an interest in a copyright to another presents the question of who will realize the subsequent income from the copyright interest—the donee or the donor under an assignment-of-income theory. The IRS has ruled that a copyright holder who assigns sufficient interest in a copyright is not liable for the tax on income derived from the transferred rights; the income from the exploitation of those rights will be attributed to the donee. Rev Rul 71-33, 1971-1 Cum Bull 30 (no income realized by taxpayer who conveyed all right, title, and interest in manuscript); Rev Rul 54-599, 1954-2 Cum Bull 52 (copyright holder who transfers exclusive right to exploit a copyrighted work in a specific medium, such as a motion picture, not liable for tax on income derived from transferred rights). However, an assignment of a royalty interest in copyright may be treated as an assignment of income if the donor retains power and control over the copyright interest. *Commissioner v Sunnen* (1948) 333 US 591, 92 L Ed 898, 68 S Ct 715 (involving patents). Compare *Walter J. Moore,* TC Memo 1968-110 (assignment of all royalties from English version of book to author's children was anticipatory assignment of income, thus still taxable to author) with *Meisner v U.S.* (8th Cir 1998) 133 F3d 654 (assignment of undivided 40-percent interest in artist's royalties under divorce agreement resulted in income to assignee, not assignor; assignment analogized to a sale).

Copyrights are also subject to depreciation and may be charged off, taking the term of the copyright into consideration. See *Taylor v Commissioner* (1931) 51 F2d 915, 917.

If the decedent granted a license involving a work of art before his or her death (*e.g.,* exploitation of a copyright), the IRS position on income in respect of a decedent (IRD) can be summarized as follows:

- Royalty payments due and accrued before the decedent's death under the agreement are IRD. Rev Rul 60-227, 1960-1 Cum Bull 262 (involving patents).
- Royalty payments accrued after the decedent's death are not IRD but are ordinary income for the recipient under IRC §61. IRS Letter Ruling 9549023.

If the artist sold the work during his or her lifetime and all amounts payable under the contract have been earned but will be paid postdeath (*e.g.,* installment sale, amounts contingent on volume of sales), those amounts will constitute IRD. IRS Letter Ruling 7830022. If the artist did not sell the works during his or her lifetime, the beneficiaries of the estate will not realize IRD when selling the works after the artist's death. Furthermore, the legatees of the copyright interests receive a stepped-up basis in the copyrights. IRS Letter Ruling 9549023.

For further discussion of IRD, see California Decedent Estate Practice, chap 33 (2d ed Cal CEB 2009).

© The Regents of the University of California

§8.19 2. Charitable Contributions of Copyright

Historically, a charitable gift of a copyright by the author or by a transferee with carryover basis was treated as a gift of ordinary income property, and the donor's charitable income tax deduction for a gift of such property was limited to his or her adjusted cost basis in the property. IRC §§170(e)(1)(A), 1015, 1221(a)(3). See §7.10. A charitable gift by a person who acquired the copyright from another for consideration and who held the copyright for more than 1 year was treated as a gift of long-term capital gain property. The deduction for such a gift to a public charity or private operating foundation was based on the fair market value of the work and will be subject to 30 percent of the taxpayer's contribution base. IRC §170(b)(1)(C)(i). See §§7.12, 7.14.

The American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418) significantly changed the calculation of the charitable income tax deduction for a charitable gift of a copyright interest for contributions made after June 3, 2004. A summary of the provisions is included in §8.31.

The charitable gift must either be all or an undivided portion of the donor's entire interest in the property in order to be deductible for income tax purposes. The partial interest rule denies an income tax deduction to a donor who transfers some rights but retains other substantial rights in the gifted property. IRC §170(f)(3)(A), (B)(ii); Reg §§1.170A-5(a)(2), 1.170A-7(b)(1)(i). The rule applies even if a donor has previously disposed of an interest in the property and now gifts the entire remaining interest to charity. For discussion of fractional gifts of tangible personal property, see §§7.26-7.28G.

Under copyright law, the copyright and the object embodying the copyright are two different assets. 17 USC §202. The transfer of the object (*e.g.,* a painting) does not convey the artist's copyright in the painting. Treasury regulations ignore this distinction for income tax purposes. Thus, the creator of the work will generally be required to gift both the copyright and the underlying tangible property associated with the property (such as the original painting or other work of art) in order to obtain a charitable income tax deduction for the gift of the copyright. Reg §1.170A-7(b)(1)(i). Regulation §1.170A-7(b)(1)(i) includes the following example:

[A] deduction is not allowable for the value of an immediate and perpetual gift not in trust of an interest in original historic motion picture films to a charitable organization where the donor retains the exclusive right to make reproductions of such films and to exploit such reproductions commercially.

For further discussion of retained copyright interests in a work of art, see §7.43.

© The Regents of the University of California

§8.20 3. Gift and Estate Tax Issues

Copyright assets owned by an individual author's estate are items of intangible personal property. The value of a copyright will depend in large part on the income stream associated with the copyright. If the author's estate is substantial, it may be advantageous to transfer interests in the copyrights during the author's life using limited liability companies (LLCs) or partnerships as control entities. These entities provide the author with the power to continue to exploit the copyrights while gifting or selling interests in the ownership entity to the intended beneficiaries. An LLC or a partnership will likely be a better vehicle than a corporation (whether C or S) because the LLC and partnership structures and the partnership income tax rules provide the opportunity for a partial basis adjustment to the copyright interests on the death of the author for the portion of the LLC still owned by the author. IRC §754.

In any case, the gifts should be valued after taking into account the appropriate discounts for lack of control and lack of marketability of the entity interest being transferred. For entity valuation planning, see chap 1.

For estate tax purposes, contrary to the partial interest rule applicable for income tax purposes, "qualified contributions" of works of art *can* be made to charitable organizations without conveying the underlying copyright; the property and the copyright interests are considered separately. IRC §2055(e)(4). See §§7.42-7.43. Gift and estate tax charitable deductions are allowed for gifts of copyright interests separate from the underlying work or for a gift of the work while retaining the underlying copyright. For a gift of art to be a "qualified contribution," the donee charity must have a tax-exempt purpose that can be served by use of the donated property. IRC §2055(e)(4)(C). This rule is similar to the rule that permits a fair market value income tax charitable deduction for a gift of appreciated personal property to a charitable organization.

What is the result if an interest in a copyright that is subject to renewal rights or termination rights (see §§8.15-8.16) is given to a charity? It would appear that such a bequest would not fail to qualify for the estate tax charitable deduction because individuals other than the charity do not have a sufficient interest in the copyright. IRC §2055(e)(2). Because the potential contingent right is a mere expectancy until the renewal period arrives, at which point the class of potential interested parties can be identified, no third parties have an interest in it at all. Only at the time of vesting does a third party gain an interest. See *Capano Music v Myers Music, Inc.* (SD NY 1985) 605 F Supp 692, 695; *Venegas Hernandez v Peer Int'l Corp.* (D PR 2003) 270 F Supp 2d 207, 214.

© The Regents of the University of California

§8.21 4. Marital Deduction Issues

Will a marital bequest of a copyright interest subject to renewal or termination rights fail as a nondeductible terminable interest? In the case of a termination right, the surviving spouse will hold 50 percent of the termination right. However, more than 50 percent is required to exercise that right and cause the copyright to vest in the spouse, children, or grandchildren. Because the spouse would be required to join with a child or grandchild to constitute a majority interest, no other person would have the ability to divest the spouse or a marital trust of the marital bequest. Thus, an outright gift or bequest of the copyright interest to the surviving spouse will qualify for the estate tax marital deduction as long as (1) no other interest in the copyright has passed for less than full and adequate consideration to some other person (IRC §2056(b)(1)(A)) and (2) no other person will enjoy any part of the copyright interest after termination of the copyright interest. See Reg §20.2056(b)-1(c).

© The Regents of the University of California

§8.22 5. Valuation Issues

The valuation of copyrights for gift and estate tax purposes provides both a challenge and an opportunity for the planner. If interests in the copyright have been transferred in exchange for royalty payments, the appropriate valuation approach will focus on the value of the future royalty income stream. Rev Rul 68-109, 1968 Cum Bull 327; Rev Rul 59-60, 1959-1 Cum Bull 237. A common approach is to multiply the average annual royalty income for the past few years by a conservative earnings factor. Hood, *Valuation: General and Real Estate,* Tax Management Portfolios 830-2d, p A-81 (2003) (suggesting multiple of three to five times average annual earnings). An alternative approach would be to estimate the future income stream, take into account the risk of change, and discount the amounts to present value.

Federal registration has an enormous impact on the market value of a copyright in litigation. Federal registration is not required to secure copyright protection, which post-1977 arises at the moment of creation. However, federal registration gives the copyright owner the right to statutory damages that can reach $150,000 per willful act of infringement (17 USC §501) and attorney fees (17 USC §505).

AUTHOR'S ADVICE: To ascertain the market value of a copyright in litigation, check for the existence of a proper registration certificate and consider contacting a copyright damages expert who can ascertain reasonable royalty rates for similar works.

Should the right to a renewal term in a copyright or the termination right be valued separately from the copyright itself? If the author dies before the renewal or termination period, followed by the spouse's death before the applicable period, will the renewal term or the termination right result in additional value in the spouse's estate? The author has found no case or other published authority addressing these questions. However, the surviving spouse had no more than an expectancy in the renewal or termination right, so when the spouse fails to survive, he or she should have no interest to be valued for estate tax purposes. See *Capano Music v Myers Music, Inc.* (SD NY 1985) 605 F Supp 692, 695 (until copyright renewal period arrives, renewal rights are not vested in anyone; the most anyone can claim is mere expectancy or contingent interest); *Hernandez v Peer Int'l Corp.* (D PR 2003) 270 F Supp 2d 207, 214 (copyright renewal term may not be assigned, because renewal rights do not vest until renewal period arrives).

© The Regents of the University of California

§8.23 6. Liquidity

The inclusion of copyright interests in an estate can present liquidity problems. The copyright or royalty interests may be included at a significant value (a multiple of annual earnings), but the annual income may be insufficient to pay the estate tax attributable to the interests. A planner faced with this problem should address this issue as with any other illiquid asset of an estate. The estate could sell the interest, perhaps thereby establishing its value for estate tax purposes but, equally likely, diminishing the value of the interest for the estate. If the copyrights are owned by an entity that qualifies as an active trade or business and constitutes a sufficiently large part of the gross estate, perhaps deferral of estate tax will be available. IRC §6166. See §§3.79-3.103. Finally, life insurance may be an appropriate solution to the liquidity problem.

© The Regents of the University of California

§8.24 III. PATENTS

Ownership of a patent begins with an invention. The grant of a patent by the federal government provides the inventor with the *exclusive* rights with respect to the patentable claims of the invention, thus providing a monopoly for the term of the patent on the specified claims and the right to exclude others from practicing the claimed invention.

© The Regents of the University of California

§8.25 A. Brief History of U.S. Patent Law

Congressional authority to establish patents is found in the same clause of the United States Constitution as copyrights. US Const art I, §8, cl 8 (see quotation in copyright discussion in §8.3). Congress enacted the first patent law in 1790, the same year as the first Copyright Act. Act to Promote the Progress of Useful Arts, Ch 7, 1 Stat 109 (Apr. 10, 1790). United States patent law went through a number of substantive amendments and revisions until 1952, when a new Patent Act was enacted and codified in USC Title 35. Ch 950, §1, 66 Stat 792. The 1952 Act, as amended, continues to govern patent law today.

© The Regents of the University of California

B. Grant of Patent by Patent and Trademark Office

§8.26 1. Application

In order to obtain the grant of a patent, the inventor must apply for the issuance of a patent. 35 USC §116. Application is made to the United States Patent and Trademark Office (PTO). Applications for joint inventions must be made by all the inventors. 35 USC §116; 37 CFR §1.45. If the inventor dies or becomes incapacitated before applying for the patent, his or her legal representative may apply in the place of the inventor. 35 USC §117; 37 CFR §§1.42-1.43.

© The Regents of the University of California

§8.27 2. What Is Protected by Patent Grant

Although some would characterize the patent grant as a right to make, use, and sell the invention, in fact the patent grant is the right *to prevent others* from making, using, offering for sale, or selling the invention or importing the invention into the United States. 35 USC §§154, 271(a).

© The Regents of the University of California

§8.28 3. Patent Duration

Patents have much shorter lives than copyrights. The former United States rule provided that patents lasted for 17 years from the date of issuance of the patent by the PTO. Former 35 USC §154.

The Uruguay Round Agreements Act of 1994 resulted in an amendment to 35 USC §154, changing the patent term to 20 years from the date of *filing* the patent application. Pub L 103-465, 108 Stat 4809. This applies to existing patents and to applications for new patents. 35 USC §154.

WARNING: Maintenance fees must be paid to the Patent Office at predetermined intervals for patents to remain valid and enforceable. 35 USC §41(b). Practitioners should consider consulting with patent counsel to make sure deadlines are not missed.

Because the patent grant now runs from the date of *filing* the application rather than from the date of *issuance* of the patent, delays in the processing of the patent application can work to the disadvantage of the inventor. Thus, if the PTO delays adjudication of the application or if the patent adjudication is delayed due to regulatory review, the law provides for an extension of the patent term. 37 CFR §§1.701-1.703, 1.710-1.791.

© The Regents of the University of California

§8.29 4. Ownership

A patent is an item of intangible personal property. 35 USC §261. Applications for patents, the patents themselves, and any interests in patents may be assigned in writing. 35 USC §261. The assignment should be recorded with the PTO. This protects the assignee from claims by a future bona fide purchaser of patent rights without notice of the prior assignment. To be effective against such claims, the assignee should record the assignment within 3 months of the date of assignment or before a subsequent bona fide purchaser acquires a new assignment without notice. 35 USC §261.

Joint ownership of a patent produces its own complications. Patent law explicitly provides for ownership by two or more owners, either because there were two or more inventors or because of a subsequent transfer of an interest in the patent by the inventor to another. If a patent is jointly owned, each owner has the right to exploit the patent without the consent of the co-owners and without accounting to the co-owners. 35 USC §262. The ability of a co-owner to license a third party to use the invention creates a very real risk that the value of the patent on an invention will be diminished by the action of a co-owner. To protect the value of the patent, it is important to have an agreement limiting or regulating the ability of any one co-owner to take such an action.

Patents created by a married inventor in California are subject to the general community property rules. See Fam C §1100. See §8.13. California law includes income from patent rights as part of an individual's "earnings" that may be subject to an earnings assignment order for support. Fam C §5206. See *Finnegan v Finnegan* (1944) 64 CA2d 109, 148 P2d 37 (discussing court's procedure to compel husband to assign patent rights to wife in connection with award for spousal support).

Unlike copyrights, however, there is no system of renewal rights or termination rights that is intended to benefit the inventor or his or her family. Instead, with the assignment of interests in patents, what you see is what you get.

© The Regents of the University of California

C. Tax Issues of Patents

§8.30 1. Income Tax Character of Patents

Patents are accorded more favorable income tax treatment than copyrights. Although copyrights in the hands of the author generally are excluded from the definition of capital asset (see §8.18 regarding capital gains treatment for songwriters), gain on the transfer of all substantial rights in a patent or of an undivided interest in such rights by the inventor is treated as a long-term capital gain, regardless of how long the patent rights have been held by the inventor. IRC §1235(a). Transfers by gift, inheritance, or devise are specifically excluded from the operation of this rule. But for the specific exclusion of inter vivos gifts and transfers at death, the favorable provisions of IRC §1235(a) would operate to trigger a capital gain in a transfer that would not otherwise be a realization event. Capital gains treatment also applies if the payments are made to the inventor over the period that the transferee will use the patent or if the payments are contingent on the success of the patent. IRC §1235(a)(1)-(2). Transfers to related persons are excluded from application of this rule, and the income tax consequences of such transfers will be determined by reference to other provisions of the Internal Revenue Code. Reg §1.1235-1(b). Related persons have been defined as spouses, ancestors, lineal descendants, specific relationships between entities (such as an individual and a corporation in which the individual, directly or indirectly, owns more than 25 percent of the outstanding stock), or a trustee and a beneficiary of a trust. IRC §1235(d).

© The Regents of the University of California

§8.31 2. Charitable Contributions of Patents

Although gifts of copyrights are subject to the partial interest rule that generally requires the copyright holder to donate the underlying work with the copyright in order to secure an income tax deduction (IRC §170(f)(3)(A); Reg §1.170A-7(b)(1)(i)), gifts of interests in patents are not subject to this restriction. However, the partial interest rule does apply to the donor's interest in the patent itself. Thus, the donor who wishes to transfer less than his or her entire interest in the patent must transfer an undivided fractional interest in all the substantial rights to the patent. Reg §1.1235-2(b)-(c).

Although charitable gifts of patents are treated as gifts of long-term capital gain property under IRC §1235, any depreciation recapture amount will be subtracted from the fair market value of the patent in computing the income tax deduction. IRC §170(e)(1)(A).

The American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418) markedly changed the computation of the charitable income tax deduction available for the charitable contribution of a patent (or a copyright) after June 3, 2004. The initial charitable deduction is now limited to the donor's basis in the donated interest. IRC §170(e)(1)(B)(iii). If the donor notifies the donee charity that the contribution is a "qualified intellectual property contribution," the donor may be entitled to additional charitable deductions for up to 10 years after the gift, computed by reference to the "qualified donee income" received by the charity on account of the donated interest in the years after the gift. IRC §170(m). Additional deductions will only be available if and to the extent the charity's qualified donee income on account of the donee interest exceeds the initial deduction claimed by the donor. Qualified donee income received more than 2 years after the year of contribution is reduced by a sliding scale percentage set forth in IRC §170(m)(7).

© The Regents of the University of California

§8.32 3. Gift and Estate Tax Issues of Patents

In contrast to copyrights, gifts and bequests of interests in patents are not subject to the power of another to revoke the transfer and acquire the patent interest. Thus, the disposition of interests in patents is more straightforward.

The fact that a patent has a relatively short life (20 years, more or less) does not mean that it is a terminable interest that will fail to qualify for a gift tax or estate tax marital deduction. Although the interest will terminate on a lapse of time (IRC §2056(b)(1); Reg §20.2056(b)-1(b)), an outright gift or bequest of the patent holder's interest will qualify for the marital deduction as long as (1) no other interest in the patent has passed for less than adequate consideration to someone other than the spouse (IRC §2056(b)(1)(A)) and (2) no other person will enjoy the benefits of the patent interest after the termination of the patent (IRC §2056(b)(1)(B)). See Reg §20.2056(b)-1(c).

© The Regents of the University of California

§8.33 4. Liquidity

Liquidity issues may be presented by patents or patent royalties owned in an estate. The discussion of liquidity issues involving copyrights is equally applicable to patents. See §8.23.

© The Regents of the University of California

§8.33A IV. TRADEMARKS

A trademark (or service mark) is a distinctive mark that identifies the source of goods or services. Generally, the owner of a trademark may prevent others from infringing, *i.e.,* using identical or confusingly similar marks to identify goods or services from a source other than the trademark owner.

© The Regents of the University of California

§8.33B A. Brief History of Trademark Law

Soon after a specialized merchant class began making goods for others, merchants began marking their wares with words or symbols identifying the maker. Backed by the reputation of the maker, these marks advertised the goods as having a certain quality. At the same time, others attempted to use the established reputation of those merchants by trading their own goods under the merchants' marks.

The common law tort of "passing off" developed to prevent the misrepresentation of goods or services as the goods or services of another. From this common law tort, state statutory trademark law evolved and remains applicable today.

Trademarks were protected only under state law in the United States until 1870, when Congress first enacted a trademark statute (Ch 230, 16 Stat 198 (July 8, 1870)). Justified as an extension of powers granted by the copyright clause of the Constitution (US Const art I, §8, cl 8), the first federal trademark statute was struck down by the United States Supreme Court in *Trade-Mark Cases* (1879) 100 US 82, 25 L Ed 550. In 1881, Congress enacted a trademark statute (Ch 138, 21 Stat 502 (Mar. 3, 1881)) under the commerce clause (US Const art I, §8, cl 3). Since that time, federal trademark law has undergone major revisions in 1905 (Ch 592, 33 Stat 728 (Feb. 20, 1905)) and 1946 (Trademark Act of 1946 (Lanham Act) (Ch 540, 60 Stat 427)). Currently, the 1996 revision of the Lanham Act (15 USC §§1051-1127) defines the scope of federal protection of trademarks. Unlike copyrights and patents, which are protected exclusively under federal law, trademarks are protected under concurrent state and federal jurisdiction.

© The Regents of the University of California

B. Establishing and Maintaining Trademark Rights

§8.33C 1. State Protection

State trademark protection is most easily obtained by being the first to adopt a trademark and use it in connection with goods or services. This is known as "common law rights from use." State statutory protection is obtained by filing an application with the state trademark office or, as in California, the secretary of state (Bus & P C §14207). State trademark protection is limited to the geographic area in which the trademark is actually used. See, *e.g.,* Bus & P C §14202(h). Those relying on state trademark law for protection cannot use the federal trademark registration symbol ®, but they can use the symbol for trademark (or ^{SM} for service mark). The duration of state registered trademarks varies from state to state, but common law trademarks endure as long as use of the trademark continues.

© The Regents of the University of California

§8.33D 2. Federal Protection

Federal trademark protection under the Lanham Act is obtained by filing an application with the United States Patent & Trademark Office. 15 USC §1051. Federal registration is limited to trademarks used or intended to be used in interstate commerce. 15 USC §1127 (definition of "commerce), §1051(a)-(b). A federal registrant may give notice that his or her trademark is registered by displaying the symbol ®. 15 USC §1111. A certificate of federal trademark registration remains in effect for 10 years (15 USC §1058) if an affidavit of continued use is filed in the sixth year; it may be renewed for any number of successive 10-year terms as long as the mark remains in commercial use. 15 USC §1059.

NOTE: Federal registration provides national protection of the mark or name even if the business is not engaged in nationally.

© The Regents of the University of California

§8.33E 3. Trademarkability

In addition to being used in commerce, a trademark must be distinctive, *i.e.,* it must distinguish its associated product from competitors' products. See 15 USC §1052. The distinction may be inherent (*e.g.,* Xerox copiers) or acquired when the mark has attained a secondary meaning over time (*e.g.,* American Airlines).

Although a trademark is usually a word or a phrase, it may also be a nonverbal distinction. Sounds, colors, fragrances, shapes, and other distinctive features that identify the origin of a product are eligible as trademarks. Examples of these are the distinctive chimes of NBC, registered in 1950, and the identifying shape of a Coca-Cola bottle, registered in 1960.

Internet domain names may also receive trademark protection. Mere registration of a domain name, however, does not afford trademark rights. The domain name must be used to identify particular goods or services, such as the way Amazon.com identifies a particular online shopping service. The trademark protection extends to the mark used in the domain name.

© The Regents of the University of California

§8.33F *4.* Maintenance

The value of a trademark lies in its ability to distinguish a product from competing products and to prevent the public from being misled about the origin or quality of the goods or services provided. Because these functions can only be maintained by customer association of the mark with the good or service, a trademark remains valid only as long as it remains in actual commercial use as a source identifier. If a trademark is abandoned, *i.e.,* its use is discontinued for a specified time, the trademark is no longer valid. See 15 USC §1127 (definition of "mark" and "abandonment"), §1058(a). If statutory trademark registration is allowed to lapse, the rights of the trademark owner are relegated to nonstatutory common law rights.

© The Regents of the University of California

C. Trademark Issues for Estate Planners

§8.33G 1. Family Businesses: Sole Proprietorships or Closely Held Corporations

A trademark is often the key value of a small business because it reflects the goodwill associated with a sole proprietorship or a closely held corporation. When the owner dies, the heirs will often want or need to continue running the family business, and trademark issues may arise. If the small business has filed a federal trademark registration, the new manager must file the appropriate federal forms so that the mark is not deemed abandoned. An abandoned mark means competitors could enter the market using the name, potentially destroying the goodwill and the value of the business.

If the owner died without registering a state or federal trademark, the goodwill associated with the name is only protected by common law. In the process of marshaling assets in the trust or probate context, the new owners should strongly consider filing a federal or state application to formally protect the mark.

AUTHOR'S ADVICE: Marks are often lost because the requisite statements of continued use are not filed. This can potentially allow competitors to enter the market, severely limiting future growth prospects for the business. Counsel should send clients to a trademark attorney and document the fact that they advised them to seek trademark counsel regarding protection of the mark.

© The Regents of the University of California

§8.33H 2. Personal Name Marks

Often a small family business has been built around a person's name, *e.g.,* Joe's Coffee Shop. If the owner dies without registering the name at the state or federal level, the mark and the name of the business are not lost. The goodwill associated with the name and any trademark rights that existed in the name before the owner's death continue to exist, and the company can continue under that name. However, the heirs who are running the business should consider filing a trademark application that reaches back to the earliest date of known and provable use.

Iskenderian v Iskenderian (2006) 144 CA4th 1162, 51 CR3d 163, illustrates the complexities of trademarks in small family businesses. In that case, a family opened the Zankou Chicken restaurant in Los Angeles. Over the years, the extended family opened and worked in several other restaurants with the same name. When the founder died, the court held that the extended family members jointly owned the mark. That meant that the consistency of the mark across restaurants with the same name could change, potentially damaging the long-term value of the mark.

AUTHOR'S ADVICE: Family businesses are often run by many members of a family, *e.g.,* several fast food outlets under a given name run by the founder, his or her siblings, and all their children. When the founder dies, different family members will often start to run different restaurants. Without securing formal protection for the trademark and clearly delineating in license agreements who can do what with the mark, the remaining splintered family could potentially lose all trademark rights in the name because of their divided use. Counsel should advise such clients to consult a trademark attorney so that a formal structure can be created to hold the trademark and to license its use on consistent terms.

© The Regents of the University of California

§8.33I 3. Trademark Assignments in Wills or Trusts

Because a trademark is a symbol of goodwill, a trademark cannot be assigned in gross, *i.e.,* divorced from its goodwill. See 15 USC §1060(a). Thus, an owner of a business operating under a name can transfer to his or her heirs the trademark, but the goodwill must go with it. For example, if the restaurant owner in *Iskenderian v Iskenderian* (2006) 144 CA4th 1162, 51 CR3d 163 (see §8.33H), had left the mark to his children but not the restaurant, which is the embodiment of the goodwill of the mark, the trademark assignment would have been void.

AUTHOR'S ADVICE: For family businesses with trademark goodwill value, make sure that any purported assignment of the trademark in trust or will documents accompanies the goodwill of the business. Estate planning documents should not include naked mark transfers.

© The Regents of the University of California

V. CALIFORNIA STATUTORY RIGHTS

§8.34 A. State Law Bonus to Artist for Subsequent Sales of Fine Art

Civil Code §986 provides for a payment equal to 5 percent of the resale price of an item of fine art if the seller resides in California and the artist is a United States citizen or has been a resident of California for at least 2 years. "Fine art" includes an original painting, sculpture, or drawing or an original work of art in glass. CC §986(c)(2). This rule does not apply to the initial sale by the artist or to items selling for less than $1000. CC §986(b)(1)-(2). Following the death of the artist, the provisions of CC §986 inure to the benefit of "his or her heirs, legatees, or personal representative, until the 20th anniversary of the death of the artist." CC §986(a)(7). Although the statutory language lacks the clarity of the Copyright Act in defining successors who hold termination rights (will the heirs, legatees, and personal representative all share and share alike?), the appropriate disposition of this right should be considered for the estate of a successful artist.

© The Regents of the University of California

§8.35 B. Publicity Rights

In California, the Astaire Celebrity Image Protection Act (ACIPA) (CC §3344.1) prohibits the use of a deceased personality's name, voice, signature, photograph, or likeness in advertising without the consent of the person or persons to whom the right of consent has been transferred or has passed to as defined under the ACIPA. Stats 1999, ch 998, 1000 §9.5, renumbering and amending former CC §990 (Stats 1984, ch 1704). The protection previously given to a living person's right of publicity by CC §3344 was expressly extended to deceased personalities in the wake of a landmark case that held that the right to exploit name and likeness is personal to the individual and does not survive his or her death. *Lugosi v Universal Pictures* (1979) 25 C3d 813, 160 CR 323. Civil Code §3344.1 was amended and renamed after a court held that an advertisement for instructional dance videos using Fred Astaire film clips was an exempt use under former CC §990. *Astaire v Best Film & Video Corp*. (9th Cir 1997) 116 F3d 1297, cert denied (1998) 119 S Ct 161.

A deceased personality's images are considered property rights and freely transferable, by contract or testamentary disposition. CC §3344.1(b). If the celebrity does not dispose of these rights during his or her lifetime and also fails to do so in a testamentary disposition, the rights belong to the celebrity's protected class consisting of (1) surviving spouse, (2) children, (3) grandchildren, or (4) parents. The entire interest belongs to the surviving spouse if there are no surviving children or grandchildren. The surviving spouse must share one-half with the surviving children and the surviving children of any dead child, if any. If there are surviving children or grandchildren, the surviving spouse receives one-half, and the other half is divided among the surviving children and grandchildren, by right of representation. If there is no surviving spouse, the entire interest is divided among the surviving children and the surviving children of any dead child, by right of representation. If there is no surviving spouse, children, or grandchildren, the entire interest belongs to the surviving parent(s). CC §3344.1(d). The rights may be exercised only by persons who are entitled, in the aggregate, to more than a 50-percent interest in the rights. CC §3344.1(d).

The interest terminates if the deceased personality did not transfer the interest and there are no surviving members of the celebrity's protected class as described under the ACIPA. CC §3344.1(e).

The period of publicity rights protection for a deceased celebrity extends for 70 years after the celebrity's death. CC §3344.1(g). The law also applies, however, to any person who died within 70 years before January 1, 1985. CC §3344.1(h).

Although California law creates a property right in these images, the income from the sale of these rights may be ordinary income rather than capital gain. *Miller v Commissioner* (5th Cir 1962) 299 F2d 706. The court's decision in that case was based on the conclusion that the taxpayer's interest was not "property" for the purposes of IRC §1221.

A discussion of the First Amendment issues involved is beyond the scope of this chapter, but the ACIPA does provide a safe harbor provision for the use of a celebrity's image unless it is so directly connected with a product, article of merchandise, good, or service as to constitute advertising. CC §3344.1(a)(3).

Although prohibition of digitally altering imagery of a person's likeness was specifically dropped from the ACIPA, it remains a hot topic and may lead to further amendments.

© The Regents of the University of California

9

Estate Planning for Restricted Securities

Russell G. Allen
Don R. Weigandt

I. INTRODUCTION §9.1

II. CONSTRAINTS ON RESTRICTED SECURITIES §9.2
- A. Federal Securities Law §9.3
  - 1. Rule 10b-5 §9.4
  - 2. Rule 144
    - a. Application of Rule §9.5
    - b. Holding Period §9.6
    - c. Company Reporting Requirements §9.7
    - d. Volume Limits §9.8
    - e. Manner of Sale §9.9
    - f. Investor Reporting Requirements §9.10
  - 3. Rule 145 §9.11
  - 4. Section 16 §9.12
    - a. Estate Transactions §9.12A
    - b. Trust Transactions §9.12B
  - 5. Section 13 §9.13
- B. State Securities Law §9.14
- C. Federal Tax Law §9.15
  - 1. Deferring Gain Recognition §9.16
  - 2. Compensatory Stock and IRC §83(b) Election §9.17
  - 3. Restricted or Control Stock at Death §9.18
  - 4. IRC §6166 Opportunity §9.19

III. PLANNING ALTERNATIVES DURING LIFETIME
- A. Nonvested, Compensatory Stock §9.20
- B. Restricted or Control Stock
  - 1. Sell Part to Diversify §9.21
    - a. Diversification Issues for Individual Investor
      - (1) Holding Versus Selling Analysis §9.22
      - (2) Practical Considerations in Selling §9.23
    - b. Securities Law Considerations in Selling §9.24
  - 2. Give Part to Charity
    - a. Types of Charitable Gifts §9.25
    - b. Reporting Requirements for Charitable Gifts §9.26
    - c. Constraints on Charitable Entities §9.27
  - 3. Transfer Part to Family §9.28
    - a. Outright Gifts §9.29
    - b. Transfers to Trusts
      - (1) IRC §2036 Problem §9.30
      - (2) Transfer to GRAT §9.31
        - (a) Rule 144 Requirements §9.31A
        - (b) Section 13(d) Requirements §9.31B
        - (c) Section 16 Requirements §9.31C
        - (d) After GRAT's Annuity Term §9.31D
    - c. Installment Sales to Individuals or Trusts §9.32
    - d. Contributions to Limited Partnerships or Limited Liability Companies §9.33
  - 4. Invest Part in Exchange Fund §9.34
  - 5. Borrow §9.35
  - 6. Hedge Risk With Derivative Transaction §9.36
    - a. Derivative Transaction Terminology §9.37
    - b. Put Options §9.38

c. Diagram: Put Options §9.39
d. Cashless Collar §9.40
(1) Diagram: Cashless Collar §9.41
(2) Reporting Requirements; Estate Tax Consequences §9.42
(3) Disadvantages for Insiders §9.43
(4) Put and Call Options Within GRATs §9.44
(5) Diagram: Economics of Option Transactions Within GRATs §9.45
7. Combine Borrowing, Hedging, and Tax Deferral With Prepaid, Variable Delivery Forward Sale
a. Prepaid, Variable Delivery Forward Contracts §9.46
b. Diagram: Personal Exchange Funds §9.47
8. Increase Insurance Coverage §9.48

IV. PLANNING FOR POSTDEATH ADMINISTRATION §9.49
A. Selection of Fiduciary §9.50
B. Estate Protection Option
1. Hedging Versus Selling §9.51
2. Table: Example of Hedging as Estate Protection Option §9.52
C. Drafting Considerations
1. Retention of Securities §9.53
2. Discretion to Sell §9.54
3. Borrowing and Investing §9.55
4. Exculpatory Language §9.56
5. Valuation and Distribution Problems §9.57
6. Consider Charitable Gifts §9.58

V. APPENDIXES
A. Form: Resolving Conflicts for Corporate Trustees in Relation to Investments §9.59
B. Matrix of Securities Law Considerations Related to Restricted or Control Stock §9.60

© The Regents of the University of California

§9.1 I. INTRODUCTION

Estate planning for clients with restricted securities presents an unusual series of challenges and a number of alternative ways of dealing with them. Rarely is any one strategy appropriate during a lifetime; usually, a combination of strategies is advisable. Some techniques focus on income tax deferral (with the hope of a basis step-up at death), risk-hedging, and diversification, and some focus on income tax and transfer tax savings opportunities. After death, restricted securities again present challenges and, occasionally, opportunities. In either event, the securities law considerations that apply to restricted and control stock and diversification are likely to be significant issues. As always, the most fundamental questions and most important considerations begin with the values, goals, and constraints (both legal and otherwise) of the estate planning client.

© The Regents of the University of California

§9.2 II. CONSTRAINTS ON RESTRICTED SECURITIES

There are various constraints involved in estate planning for the holders of publicly traded, restricted securities. These include the Securities Act of 1933 (Securities Act) (15 USC §§77a-77aa), the Securities Exchange Act of 1934 (Exchange Act) (15 USC §§78a-78mm), the federal income tax law, and the federal transfer tax laws. Moreover, the interplay between the securities and tax laws is particularly important.

Founders of companies that have gone public are frequently constrained in order to protect investors and potential investors. Employees, directors, and early investors in business enterprises, whether they made direct investments or participated in venture capital financing, also may be constrained in their sales of company stock. At the same time, however, these shareholders may have tax-deferred reinvestment opportunities not available to other shareholders.

Some shareholders of large, publicly traded companies who were founders or early investors, as well as employees and directors, of small business enterprises that have been acquired in a tax-free exchange of stock are subject to restrictions for a limited period of time and may have tax-deferred reinvestment opportunities.

Holders of publicly traded securities (albeit subject to various securities law or employer-imposed restrictions) sometimes have more flexibility in the ownership, management, and disposition of their interests than owners of closely held business enterprises. Lenders are generally more willing to accept publicly traded stock as collateral. Stockholders in publicly traded companies may be able to hedge the risk of their holdings with derivative transactions. See §§9.36-9.45. They also may be able to combine borrowing and hedging to permit a plan of diversification, while deferring gain recognition. See §§9.46-9.47. In addition, they may be able to contribute their holdings to an exchange fund or other partnership structures to gain some measure of tax-deferred diversification. See §9.34.

Holders of publicly traded securities that are subject to securities law and contractual restrictions also need to focus on the consequences of those restrictions for postdeath administration because a trustee or personal representative may be faced with many of the same complexities and opportunities faced by the shareholder during his or her lifetime. Naming executors and trustees can be tricky, because the restrictions imposed on the person acting may affect the estate or trust and vice versa. Moreover, the alternate valuation date election for determining the federal estate tax after a shareholder dies presents a unique planning opportunity. See §§9.51-9.52.

© The Regents of the University of California

§9.3 A. Federal Securities Law

Several provisions of the federal securities law apply to holders of restricted stock. Each applies to a slightly different group of shareholders—and they frequently overlap. In almost every instance, each provision must be considered separately in the context of particular facts and circumstances.

The following sections briefly discuss Exchange Act Rule 10b-5 (17 CFR §240.10b-5; see §9.4), Securities Act Rule 144 (17 CFR §230.144; see §§9.5-9.10A), Securities Act Rule 145 (17 CFR §230.145; see §9.11), Exchange Act §16 (15 USC §78p; see §9.12), and Exchange Act §13(d) (15 USC §78m(d); see §9.13).

NOTE: In addition to these generally applicable rules and regulations, there are others that may be relevant in particular circumstances, *e.g.,* SEC Regulation BTR (17 CFR pt 245) (dealing with so-called pension fund "black-out periods"); the rules of the Financial Industry Regulatory Authority (FINRA), the non-governmental successor regulatory agency to the National Association of Securities Dealers; and the regulatory functions of the New York Stock Exchange.

Although securities experts write treatises about the intricacies of these federal laws, attorneys involved in the estate planning process simply need to be aware of them as potential constraints whenever an investor or executor/successor trustee of an investor is considering a disposition, hedge, or pledge of restricted or control stock. The estate planner should consider the following questions:

- Is the person a senior officer, director, or employee of the company or a predecessor company?
- If not, does the person own more than 5 percent?
- If not, was the stock acquired by any means other than a purchase through a broker?

If the answer to any question is yes, the federal securities laws require attention.

WARNING: Even if the shares of junior employees are not restricted or control stock, junior employees may still be subject to company-imposed policies or "lock-up agreements" that constrain their sales, hedges, and pledges.

© The Regents of the University of California

§9.4 1. Rule 10b-5

The antifraud provisions of the Exchange Act are, perhaps, the most obvious constraint to selling the securities of a public company. Rules 10b-5 and 10b5-1 (17 CFR §§240.10b-5, 240.10b5-1) supply the basic provisions. If an insider (or a person who learns from an insider) is aware of material, nonpublic information about the company and nevertheless trades, he or she will have to disgorge any profit and perhaps face treble damages and criminal charges. See Exchange Act §§21A, 32 (15 USC §§78u-1, 78ff). An affirmative defense exists, however, for an insider who entered into a contract, instruction, or plan of sale before becoming aware of the material, nonpublic information. See 17 CFR §240.10b5-1(c)(1)(i). These contracts are frequently described as "10b5-1 plans."

NOTE: Just as tax lawyers have technical, often different meanings for terms, so do securities lawyers. This chapter uses the term "insider" casually; in any particular situation, however, the attorney should refer to the precise statutory definition that applies.

To reduce the potential for securities fraud allegations, a number of companies have adopted rules for employees and directors that prevent sales except during "window" periods that follow quarterly earnings reports. Sales under 10b5-1 plans outside those trading windows may be allowed, however, if the plan was adopted during one. However, an insider may not sell nor enter into a 10b5-1 plan while the insider is in possession of material, nonpublic information about the company, even though the window period may be open. As a result, senior executives should always consult with the company's general counsel before committing to any sale, through a 10b5-1 plan or otherwise, to make sure they are not in possession of information that is material and nonpublic.

Sales under 10b5-1 plans may reduce the suspicion of "unfair" insider trading, as well as liability. The market may respond less adversely to insider sales under a prearranged plan for the disposition of stock than to what appear to be ad hoc sales. See, *e.g.,* Altman, *When Insiders' Sales Are a Long-Term Plan: A Tool for Avoiding Hints of Impropriety*, New York Times, May 19, 2002, section 3, p 1.

© The Regents of the University of California

2. Rule 144

§9.5 a. Application of Rule

Securities Act Rule 144 (17 CFR §230.144) both permits public sales without formal "registration" by the seller under certain limited circumstances and requires disclosure of sales in certain cases. Effective February 15, 2008, the SEC adopted significant changes to Rule 144 that generally eased restrictions on sale and notice requirements. See SEC Release 33-8869 (Dec. 6, 2007) for the full text of these changes and helpful commentary. As modified, Rule 144 continues to differentiate between two groups of shareholders:

- *Senior officers, directors, and certain large shareholders (and related parties).* These shareholders are called "affiliates" and, sometimes, "control persons," and their stock is called control stock, regardless of how it is acquired. See 17 CFR §230.144(a)(1). Affiliate status also attaches to certain relatives of the control person and to trusts, estates and other entities in which they and the affiliate (collectively) have 10 percent or more of the total beneficial interest or for which any such person acts as fiduciary. See 17 CFR §230.144(a)(2).

NOTE: The concept of control is not defined in Rule 144. However, securities law practitioners believe that senior officers and directors hold the requisite control to be considered affiliates. Moreover, the holder of 10 percent or more of the outstanding stock likely will be considered an affiliate. However, that might not be true for a 10-percent owner who is not active in the management of the company when a founder holding a large position in the stock (*e.g.*, 60 percent) is active in management.

- *Others who did not buy shares in a registered offering or in the public market.* These shares are called "restricted stock" or "letter stock," and the share certificates for such stock often carry legends to that effect. See 17 CFR §230.144(a)(3).

NOTE: Very small amounts of stock may fall within the restrictions, *e.g.,* a few shares obtained in a distribution from a venture capital fund usually constitute restricted stock under Rule 144, because they were not issued in a registered offering. On the other hand, the safe harbor provided for sales of restricted or control stock is not available for shares in certain "shell" companies that have few or no assets other than cash or cash equivalents. 17 CFR §230.144(i).

Technically, Rule 144 applies both to control stock and to restricted stock. Stock can have both control and restricted status if it is acquired by a control person in a private transaction, such as a pre-IPO investment. Not all control stock, however, is restricted stock. Stock acquired by an affiliate in the public markets is considered control stock, but is not restricted stock.

NOTE: Private sales are governed by §4(1)-(2) of the Securities Act (15 USC §77d(1)-(2)) and the rules promulgated under that section. Rule 144 does not apply because the safe harbor it provides is limited to sales through broker transactions. See 17 CFR §230.144(f). For discussion of private sales in the context of intrafamily sales, see §9.32.

Penalties for selling unregistered securities in the public markets outside Rule 144's safe harbor can be quite severe. In addition to cease-and-desist orders, they can include disgorgement of ill-gotten gains. See*, e.g., In re Dudchik* (Dec. 5, 2008, No. 3-12943) 2008 SEC Lexis 2856.

© The Regents of the University of California

§9.6 b. Holding Period

Restricted stock must have been issued, fully paid for, and held for at least 6 months before it can be sold under Rule 144. 17 CFR §230.144(d)(1). This holding period does not apply to stock categorized only as control stock, such as most stock obtained as a result of the exercise of compensatory stock options. See 17 CFR §230.144(d) (applicable only to restricted stock).

NOTE: The 6-month no-sale period is limited to companies ("reporting companies") that are, and have been for at least 90 days, subject to public reporting requirements of Exchange Act §13 or §15(d) (15 USC §§78m, 78o(d)). For companies ("non-reporting companies") that have not been subject to such requirements for at least 90 days, all 6-month holding period requirements are extended to 1 year. 17 CFR §230.144(d)(1). Unless otherwise stated, in this chapter it is assumed that the issuer of the securities being discussed is a reporting company.

In some cases, the holding period for restricted stock includes the period that the investor held other stock or that the stock was held by another person. See generally 17 CFR §230.144(d)(3). For example, the holding period of restricted stock acquired as a stock dividend or in a stock split generally includes the holding period of the stock on which it was issued. See 17 CFR §230.144(d)(3)(i). Similarly, the holding period of stock acquired by gift or by a trust (or beneficiary thereof) from an affiliate, and of stock held by the affiliate's estate (or beneficiary thereof), includes the period that it was held by the affiliate. See 17 CFR §230.144(d)(3)(v)-(vii).

NOTE: The special holding period rules applicable to gifts, trusts and estates technically apply only to shares acquired from affiliates. However, securities law experts generally believe that these rules apply to transfers from non-affiliates as well.

© The Regents of the University of California

§9.7 c. Company Reporting Requirements

Both control and restricted stock can be sold only if the company has current information available to the public. This condition is met if the company:

- Is a reporting company and has filed all required reports and posted on its website certain required data for the preceding 12 months; or
- Is a non-reporting company, but certain information about the company is publicly available.

See 17 CFR §230.144(c). Companies whose reports to the SEC have been delayed (*e.g.,* to permit the restatement of earnings) may not meet this requirement, thus prohibiting the sale of restricted stock under the safe harbor provided by Rule 144.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.8 d. Volume Limits

§9.8 d. Volume Limits

Rule 144 places limits on the amount of restricted and control securities that may be sold during any 3-month period. These limits now apply only to affiliates, as a result of changes to Rule 144 that eliminated volume limits for non-affiliate sales. See SEC Release 33-8869 (Dec. 6, 2007). That amount may not exceed the greater of:

- One percent of the outstanding shares; or
- The average weekly trading volume for the 4 calendar weeks before the filing of the notice of sale.

See 17 CFR §230.144(e)(1).

NOTE: Rule 144 most commonly comes into play for equity securities. Unless otherwise noted, this chapter assumes that the restricted securities under discussion are shares of stock. However, Rule 144 can also affect the sale of debt securities, but the rules applicable to debt securities are somewhat different. See, *e.g.*, 17 CFR §230.144(e)(2).

Identifying the limit is not quite as straightforward as it might appear to be, however, because sales by recipients of gifts from the affiliate, by estates and trust relationships created by the affiliate, by lenders to the affiliate, and by persons acting in concert with the affiliate are aggregated with sales by the affiliate in applying the volume limits. 17 CFR §230.144(e)(3). As a practical matter, these aggregation rules only affect how much the affiliate may transfer, since sales by non-affiliates are no longer subject to volume limits. 17 CFR §230.144(b)(1). For example, if a donor contributes restricted stock to an unrelated charity, sales by the charity during the 6-month period after the donation will count against the volume limits applicable to the *donor's* sales during the same period.

In addition, any sale by a relative of an affiliate (or a relative of a spouse of an affiliate) who has the same home as the affiliate is treated as a sale by the affiliate. See 17 CFR §230.144(a)(2)(i). The members of this class are sometimes referred to as household relatives. Similarly, a sale by a trust is treated as a sale by the affiliate if:

- The affiliate and household relatives (as a group) hold at least a 10-percent beneficial interest in the trust; or
- The affiliate or any household relative acts as trustee.

See 17 CFR §230.144(a)(2)(ii). Thus, persons and entities treated as the affiliate by virtue of their relationship to the affiliate are subject (collectively with the affiliate) to the affiliate's volume limit.

Sales by a donee or any trust to which the affiliate transferred shares are aggregated with the affiliate's sales for a period of 6 months after the transfer—even if no relative is involved. 17 CFR §230.144(e)(3)(iii)-(iv). Somewhat less stringent rules apply in the case of estates. Volume limits apply to the estate or its beneficiaries only if the estate or beneficiary is an affiliate. If the estate itself is an affiliate, however, it must take into account sales by the decedent before death and within 3 months of the sale by the estate. Hence, no aggregation is required for estate sales occurring more than 3 months after the decedent's death, even if the estate is an affiliate. See 17 CFR §230.144(e)(3)(v).

PRACTICE TIP: It is important to recognize that an estate or trust can be an affiliate in its own right, *i.e.,* if the fiduciary has affiliate status. See 17 CFR §230.144(a)(2)(ii). This will cause the estate's or trust's shares to be treated as control stock subject to Rule 144, whether or not the stock was restricted or control stock in the hands of the decedent or donor. Therefore, estate planners should be cautious about naming as fiduciaries executives or large shareholders in companies whose shares are owned by their clients. Choosing them may hinder the subsequent transfer of the estate's or trust's shares.

Unless a non-affiliate acquired the shares from an affiliate in a transaction (or has a relationship with the affiliate) requiring aggregation, sales by the non-affiliate are no longer subject to volume limits. A non-affiliate must, however, have had that status for at least 90 days before the sale. 17 CFR §230.144(e). In such cases, the only restraints on sale by a non-affiliate are the initial 6-month no-sale period and the requirement that the issuer be in compliance with the company reporting requirements. 17 CFR §230.144(b)(1).

© The Regents of the University of California

§9.9 e. Manner of Sale

Generally, restricted or control securities can only be sold by an affiliate under Rule 144 in one of three forms of transactions:

- Through a broker transaction;
- To a market maker; or
- In certain "riskless" principal transactions.

See 17 CFR §230.144(f)(1). These restrictions do not apply to sales by non-affiliates. 17 CFR §230.144(b)(1).

A broker acting as agent may receive a normal broker's commission, but no payment in connection with the sale may be made to any person other than the broker who executes the transaction. Moreover, neither the seller nor the broker may solicit or arrange for the solicitation of buy orders. 17 CFR §230.144(f)(2). The broker may contact only other brokers who have expressed an unsolicited interest in the securities within the last 60 days and customers who have expressed an unsolicited interest in the securities within the last 10 business days. 17 CFR §230.144(g)(3). A broker acting as a market maker or block positioner may purchase the securities as principal and then solicit buy orders.

PRACTICE TIP: Because the securities (whether in certificate or book entry form) may still bear a restrictive legend, the stock may need to be "cleaned up" by satisfying the company and transfer agent that it is no longer subject to the Rule 144 restrictions. Company counsel should be consulted about these issues well before any planned sale of unregistered stock, because the "cleaning" process can take several days.

© The Regents of the University of California

§9.10 f. Investor Reporting Requirements

In the case of sales by affiliates, SEC Form 144 must be transmitted for filing with the SEC and the principal exchange on which the securities are traded concurrently with placing a sell order through a broker or selling directly to a market maker if all sales in any 3-month period involve either more than 5,000 shares or an aggregate sale price in excess of $50,000. 17 CFR §230.144(h). As a practical matter, that means that a SEC Form 144 must be mailed on the day when either of those triggering events occurs.

SEC Form 144 is available online at the SEC's website: http://www.sec.gov/about/forms/secforms.htm.

As soon as the SEC receives Form 144, a copy is made available to the public. So, within a few business days, the world knows of the sale.

NOTE: The seller must have a bona fide intention to sell within a reasonable time after filing SEC Form 144. 17 CFR §230.144(h)(2). If all the securities covered by the notice are not sold within three months of the date of filing (as may happen with a 10b5-1 sales program; see §9.4), a new notice must be filed before any further sales can be made.

Sales by non-affiliates are no longer subject to the notice requirements. 17 CFR §230.144(b)(1).

© The Regents of the University of California

§9.11 3. Rule 145

Securities Act Rule 145 (17 CFR §230.145) extends many of the constraints of Rule 144 (see §§9.5-9.10) to sales of shares issued to affiliates in certain registered mergers, consolidations, and reorganizations involving "shell" companies having no or nominal operations and no or nominal assets (other than cash and cash equivalents). The nature and extent of the restrictions imposed by Rule 145 on these holders depend on their affiliate status in the acquiring company after the transaction. Three sale options are available (see 17 CFR §230.145(c), (d)):

- An affiliate of the acquirer may sell 90 days after the transaction if the company reporting, volume limits, and manner of sale requirements of Rule 144 are complied with (see §§9.7-9.9); or
- Any non-affiliate of the acquirer may sell 6 months after the transaction without constraints if the acquiring company complies with the company reporting requirements (see §9.7) and the seller was not an affiliate within the 3 months preceding the stock sale; or
- Any non-affiliate of the acquirer may sell 1 year after the transaction without any constraints if the seller was not an affiliate within the 3 months preceding the stock sale.
- The term "affiliate" as used in Rule 145 includes relatives and related entities swept into that term under Rule 144(a)(2). See 17 CFR §230.145(e)(1).

© The Regents of the University of California

§9.12 4. Section 16

Exchange Act §16 (15 USC §78p) deals with the "trading" of (as opposed to long-term "investing" in) a company's stock by insiders. It has two major components. Section 16(a) (15 USC §78p(a)) requires insiders to report initially when they become insiders and then periodically as their ownership of equity securities changes. Section 16(b) (15 USC §78p(b)) imposes penalties for realizing so-called "short-swing" profits in those securities.

Under §16(a), most senior officers, all directors, and all owners of more than 10-percent of a class of equity securities in a company that has securities registered under Exchange Act §12 (15 USC §78*l*) are required to report changes in their holdings. 15 USC §78p(a)(1). Generally, they must report changes in beneficial ownership on SEC Form 4 before the end of the second business day following the day of the change. 15 USC §78p(a)(2)(C); 17 CFR §240.16a-3(g)(1). In certain limited cases (such as bona fide gifts and bequests), annual reports on SEC Form 5 must be filed within 45 days after the end of the company's fiscal year. 17 CFR §240.16a-3(f). For these purposes, the date of filing is the date the applicable form is received by the SEC. 17 CFR §240.16a-3(h). The forms are made public immediately. They are also available on the issuer's website for at least 12 months after filing. See 17 CFR §§240.16a-3(k). Blank SEC Forms 4 and 5 may be obtained from the SEC's website at http://www.sec.gov/about/forms/secforms.htm.

If the holder is neither a senior officer nor a director, exposure to §16 depends on beneficial ownership of equity securities determined under Exchange Act §13(d) (15 USC §78m(d)). For this purpose, beneficial ownership includes all equity in which a person holds or shares the right to vote or dispose of such equity by any means, directly or indirectly. See 17 CFR §240.13d-3(a). Once it has been determined under these rules that a person owns more than 10 percent (or insider status derives from being an officer or director), exposure to §16(a) reporting requirements and §16(b) short-swing profits penalties is determined under a different set of rules, which target the person's direct and indirect pecuniary interest in equity securities and the changes in that interest. See 17 CFR §240.16a-1(a)(2).

Like Securities Act Rule 144 (17 CFR §230.144), these rules contain attribution rules, but they differ somewhat. For example, the insider is subject to a rebuttable presumption that he or she has a pecuniary interest in shares owned by "immediate family" members sharing the same household. See 17 CFR §240.16a-1(a)(2)(ii)(A), (e). Immediate family includes a child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, and sister-in-law, including adoptive relationships. See 17 CFR §240.16a-1(e). By way of contrast, the comparable provision of Rule 144 includes any relative, spouse, or relative of the spouse having the same home as the affiliate. 17 CFR §230.144(a)(2)(i).

Under §16(b), with a few exceptions, any short-swing profit realized by an insider, *i.e.,* any difference between prices on a purchase and a sale (or on a sale and a purchase) within any 6-month period must be forfeited to the company (for the benefit of all shareholders, as a group). See 15 USC §78p(b).

Although both the grant and forfeiture of compensatory restricted and control stock are exempt from the short-swing profit rules if certain conditions are met (17 CFR §240.16b-3(d)-(e)), each event is reportable on an insider's SEC Form 4. 17 CFR §240.16a-3(f)(1)(i)(A).

© The Regents of the University of California

§9.12A a. Estate Transactions

Transactions by an executor within the first year following appointment and qualification are exempt from both reporting and short-swing profits rules. After 1 year, though, the executor is exposed to the full panoply of §16 rules if the estate's ownership exceeds 10 percent. See 17 CFR §240.16a-2(d); *Luce, Forward, Hamilton & Scripps*, SEC No-Action Letter (May 21, 1992) 1992 SEC No-Act Lexis 668.

© The Regents of the University of California

§9.12B b. Trust Transactions

The rules regarding trusts are more complex. Exposure to §16 arises if the trust holds more than 10 percent determined under the beneficial ownership rules of Exchange Act §13(d) (15 USC §78m(d)), which focus on control over vote or disposition of the shares. However, beneficial ownership of trust shares is also attributed in certain cases to the trustees, beneficiaries, and settlors of a trust. This attributed ownership, when combined with any direct ownership, can push the ownership by one or more of these persons over the 10-percent threshold. See generally 17 CFR §240.16a-8(a).

If the trust is treated as owning more than 10 percent, then the trustee is required to file reports on behalf of the trust and the trust is exposed to short-wing profits forfeiture. If the trustee holds a pecuniary interest in the trust, the trustee is exposed to §16 responsibilities in an individual capacity as well. For a trustee who is not a beneficiary, this exposure can arise from a performance fee (but an asset-based fee is ignored for this purpose) or from having a member of his or her immediate family as a beneficiary. See 17 CFR §§240.16a-1(a)(2)(ii)(C), 240.16a-8(b)(2).

If a sole beneficiary has investment control over the trust's shares (*e.g.,* by also being a trustee), then only the beneficiary has to report (and navigate the short-swing profits prohibitions) with respect to the trust's shares. Similarly, if the settlor holds the power to revoke the trust without the consent of another person (as would be the case in a typical revocable "living" trust), then only the settlor is exposed to §16 responsibilities with respect to the trust's shares. 17 CFR §240.16a-8(b)(3)-(4), (d). See also *American Bar Ass'n,* SEC No-Action Letter (May 2, 1991) 1991 SEC No-Act Lexis 686; *Manatt, Phelps & Phillips,* SEC No-Action Letter (Aug. 5, 1991) 1991 SEC No-Act Lexis 930.

NOTE: The term "investment control" appears several times in 17 CFR §240.16a-8, which explains §16 coverage for shares held in trust. Although no definition is provided for this term, the SEC assumes that the ordinary powers of a trustee suffice. See *D'Ancona & Pflaum*, SEC No-Action Letter (Feb. 18, 1992) 1992 SEC No-Act Lexis 227.

© The Regents of the University of California

§9.13 5. Section 13(d)

Exchange Act §13(d) (15 USC §78m(d)) requires reporting of holdings by any person or group of persons acting together who beneficially own more than 5 percent of an outstanding class of voting equity that is publicly traded in the United States, including the equity of foreign issuers (5-percent shareholders). This reporting usually must be made within 10 days after acquisition (or sometimes on an annual basis) and after any material change in the holdings using either SEC Schedule 13D or 13G. A change is deemed material if it affects 1 percent or more of the outstanding stock. 17 CFR §§240.13d-1, 240.13d-2(a). A holder or group of holders who have less than 20 percent and meet the SEC's definition of "passive holders" can file an SEC Schedule 13G, which requires much less detailed information than an SEC Schedule 13D and which must be updated only annually. 17 CFR §240.13d-1. The information is made public immediately. SEC Schedules 13D and 13G are available online on the SEC's website at http://www.sec.gov/about/forms/secforms.htm.

NOTE: "Insider" reports filed under Exchange Act §13(d), as well as those filed under Exchange Act Rule 10b-5 (see §9.4), Securities Act Rule 144 (see §§9.5-9.10), and Exchange Act §16 (see §9.12), appear first in EDGAR (the SEC's online electronic registration system), and then on other websites such as Yahoo! Finance, CNN Money, and Quicken.com.

To determine whether a person is a 5-percent shareholder, §13(d) uses a "beneficial ownership" concept that focuses on an individually or jointly held power to vote or dispose of a security either directly or indirectly. See 17 CFR §240.13d-3(a). For example, a person who is acting as trustee should be treated as the beneficial owner of shares held by the trust, unless the trustee does not have the power to dispose of or vote the shares held by the trust. The grantor of a trust will also be attributed ownership of trust shares if the grantor holds the power to revoke the trust or otherwise to reacquire the shares from the trust. See 17 CFR §§240.13d-3(a), (d)(1)(i)(C).

For a table summarizing many of the securities law considerations relating to restricted and control stock, see §9.60.

© The Regents of the University of California

§9.14 B. State Securities Law

Although state securities laws must be considered, they have never been a constraint on the sale of publicly traded securities in the authors' experience. See, *e.g.,* Corporate Securities Law of 1968 (Corp C §§25000-25707). Sales of other interests in business enterprises sometimes are constrained, but they are beyond the scope of this chapter.

© The Regents of the University of California

§9.15 C. Federal Tax Law

Selling restricted or control stock may be part of planning for the management and disposition of a shareholder's estate and for diversifying a concentrated position. The shareholder must weigh the risks of being overly concentrated in a single security during life against the taxes and other difficulties arising from a diversification plan. By historical standards, the current federal tax on "qualified" dividends and long-term capital gains of 15 percent is not particularly high. See IRC §1(h). How long it takes to make up the tax triggered by a taxable sale of publicly traded securities depends on a number of assumptions and variables, the most important of which are:

- The basis of the stock relative to its value;
- The after-tax expected total return, volatility, and yield of the stock when compared with similar expected characteristics (and expected portfolio turnover) of "replacement" investments;
- Whether the stock will get a step-up in basis at death if retained; and
- When the death occurs.

Some financial analysts employ elaborate computer modeling, using so-called "Monte Carlo" statistical techniques (see §9.22), to evaluate the alternatives. Derivative techniques can allow cash to be withdrawn from a concentrated position without incurring tax currently, albeit with attendant costs and complexity.

© The Regents of the University of California

§9.16 1. Deferring Gain Recognition

An investor who holds "qualified small business stock" (as defined in IRC §1202(c)) may be able to reinvest the proceeds of sale in other small businesses and defer gain recognition (see IRC §1045) or take advantage of the 50-percent exclusion of gain recognized on the sale of qualified small business stock (see IRC §1202(a)). This factor will affect the analysis both of whether to sell and how to reinvest.

NOTE: The 50-percent exclusion is increased to 75 percent for sales after February 17, 2009, and before January 1, 2011. IRC §1202(a)(3).

PRACTICE TIP: In the authors' experience, many shareholders who hold small business stock actually hold the stock of large companies that have acquired small companies in stock-for-stock exchanges. See IRC §1202(f). Asking whether *any* stock was acquired other than by a purchase through a broker is often a useful question, because shareholders are sometimes unaware of this "carryover" tax benefit.

The 50-percent gain exclusion of IRC §1202(a) is often an illusory benefit, because the nonexcluded 50 percent of the gain is taxed at a 28-percent rate. See IRC §1(h)(4). This makes the effective rate of tax on the entire gain 14 percent, only one percentage point less than the current regular long-term capital gains rate. See IRC §1(h)(1). In addition, the sale can subject the seller to the alternative minimum tax (AMT), which almost entirely eliminates the benefit of the exclusion. Internal Revenue Code §57(a)(7) subjects 7 percent of the excluded gain to a 28-percent AMT rate, increasing the overall tax to 14.98 percent of the entire gain.

NOTE: During the period after February 17, 2009, and before January 1, 2011, the economics are a bit better because of the increase in the exclusion to 75 percent. During that period, the effective rate of tax on the entire gain drops from 14 percent to 7 percent, and an AMT payer's burden drops from 14.98 percent to 8.47 percent.

PRACTICE TIP: When the seller is an AMT payer, the net benefit of the exclusion is only 0.02 percent at the federal level (except for the period after February 17, 2009, and before January 1, 2011, as noted above). There may be some savings at the state level, however, especially if the seller is not an AMT payer for state purposes. The question is whether the limited tax savings justifies the added investment risks of holding such volatile stocks for the required 5-year period.

The tax-free rollover benefit of IRC §1045, however, is not predicated on a 5-year holding period. Those benefits are available to taxpayers who have held qualified stock for more than 6 months before sale. It is important to note that these benefits can extend to partners in partnerships holding qualified stock and also to stock received in a tax-free exchange for qualified stock. IRC §1202(g), (h). Consequently, obtaining qualified status for small business stock can be justified on this basis alone.

Another opportunity for gain-deferred diversification is in selling stock to the company's employee stock ownership plan. See IRC §1042.

© The Regents of the University of California

§9.17 2. Compensatory Stock and IRC §83(b) Election

Many holders acquire control stock as compensation for services provided to the issuer. Although the focus of this chapter is not on the treatment of stock options (see chap 10), control stock is frequently acquired as a result of their exercise. In other instances, control stock may be acquired as a direct, compensatory grant from the corporation. Stock grants have become more common in recent years, partially because the Financial Accounting Standards Board (FASB) requires the fair value of the options to be expensed for generally accepted accounting principles (GAAP) purposes. See FASB ASC 718, which can be accessed through the FASB website at http://www.fasb.org.

Stock received as compensation from a public company typically will have been registered in an SEC Form S-8 filing with the Securities and Exchange Commission. Frequently, the executive does not receive a vested, unrestricted right to the stock until some later event occurs.

NOTE: Unfortunately, this type of stock is commonly referred to as "restricted" stock, even though it is not restricted stock in a securities law sense. It is described as "nonvested" stock in this chapter to distinguish it from restricted and control stock.

In some situations, that later event is simply continued employment by the corporation. In others, it is meeting particular performance goals. Whatever the trigger for vesting, the employee does not have to report income until the stock becomes transferable or there is no longer a "substantial risk of forfeiture." IRC §83(c)(1). The value of the stock (less any amount paid for it by the employee) is taxed as ordinary compensation income to the employee-shareholder and is subject to employment taxes as well.

NOTE: The tax inclusion otherwise triggered by IRC §83(a) on a grant of vested stock or the exercise of a compensatory option may be deferred for up to 6 months, if the sale of that stock is subject to short-swing profit forfeiture under Exchange Act §16(b) (15 USC §78p(b)). See IRC §83(c)(3); Treas Reg §1.83-3(j). Of course, if the stock appreciates during that 6-month period, then the taxes triggered by the extended vesting period will increase as well. Generally, the acquisition of an option is treated as a purchase of the underlying security, while the exercise of that option is ignored for these purposes. See 17 CFR §240.16b-6. At least one court has held that vesting is irrelevant for this purpose. In that case, because the options had been granted more than 6 months before the sale of the stock acquired on their exercise, the court held that IRC §83(a)(3) provided no protection to the selling executive. *Strom v U.S.* (WD Wash 2008) 583 F Supp 2d 1264, 1269.

Internal Revenue Code §83(b) provides a planning alternative: The employee can elect to report the value of nonvested stock as income when it is granted (but not yet vested). The election must be made within 30 days of the time the stock is "granted," regardless of whether a certificate is delivered to the employee and when it may vest. IRC §83(b)(2). If the election is made, any appreciation in value between the grant and the lapse of the compensation-related restrictions will be taxed as capital gain rather than as ordinary income, and that appreciation will not be taxed until the stock is sold. If the holder is subject to Exchange Act §16(b), appreciation between the "normal" vesting date and the extended period will also be protected by the §83(b) election. If, however, the triggering event does not occur (because the employee leaves the company's employ or the performance targets are not met), the employee will have paid income tax on an asset that has vanished. Any deduction at that time for the loss of the stock will be limited to any amount actually paid for the stock (less any amount received at forfeiture), and the loss will be a capital loss. However, no deduction is allowed to the employee for the compensation income triggered by any prior §83(b) election. See IRC §83(b); Treas Reg §1.83-2(a).

PRACTICE TIP: In the authors' experience, the most common fact pattern in which it is advantageous to make a §83(b) election arises in the context of a start-up company, when the stock has very little value at the time it is issued to the employee. In that instance, there is relatively little disadvantage to paying income tax early and a substantial potential benefit because of the difference in rates at which ordinary income and capital gain are taxed. In addition, because the accelerated tax liability is low, the economic risk triggered by a potential forfeiture

is also low.

NOTE: For a general discussion of the income tax complexities when employees use promissory notes to acquire employer stock, see Rev Rul 2004-37, 2004-1 Cum Bull 583; Mayo, *Restricted Stock Notes*, 57 Tax Lawyer 61 (2003).

© The Regents of the University of California

§9.18 3. Restricted or Control Stock at Death

Sometimes shareholders die with nonvested stock that also is restricted or control stock. Stock not subject to forfeiture but subject to securities law restrictions because it is restricted or control stock receives a basis adjustment at death. See IRC §1014. Assuming an employee has not made a §83(b) election and dies before the compensation-based restrictions lapse and the stock vests, the value when the stock vests is income in respect of a decedent (IRD) and is reported by the employee's estate or other successor in interest. No step-up in basis is allowed. The income triggered at vesting is taxable to the estate or successor beneficiary, and not in the decedent's final return. See IRC §1014(c); Treas Reg §1.83-1(d). But see Rev Rul 68-124, 1968-1 Cum Bull 44 (bonuses payable after death in amount less than $5000 are not income in respect of decedent). If the decedent made a §83(b) election, however, the stock will not be IRD and therefore will qualify for a step-up in basis. See IRC §1014.

The value of nonvested restricted and control stock for transfer tax purposes has been the source of some controversy. In the authors' experience, nonvested stock received as compensation and subject to forfeiture is nontransferable until the employer's restrictions lapse. At that point, it may be restricted or control stock and subject to marketability and blockage discounts. In general, three questions arise:

- Is the value of the stock less than the simple product of the number of shares and the mean trading price on the date of gift or death? If the size of the holding is significant enough to affect trading materially, then a so-called blockage discount may be appropriate. See Treas Reg §20.2031-2(e); Witwer, *How to Discount Blocks of Thinly Traded Stock*, Trusts & Estates 37 (June 2003).
- What is the effect of an employer's restriction (whether continued employment or satisfaction of performance targets) that had not lapsed immediately before the employee's death? Restrictions based on length of employment almost always lapse and the stock vests when an employee dies or retires. The same is often true for performance-based restrictions, but industry practice may not be as universal in that regard. At least in the Ninth Circuit, these restrictions probably reduce the value for transfer tax purposes, even though they may lapse as a result of the employee's death. See, *e.g., Estate of McClatchy v Commissioner* (9th Cir 1998) 147 F3d 1089.
- How is any discount attributable to Rule 144 transfer restrictions determined? A number of cases have addressed this important issue. See discussion in §9.28.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.19 4. IRC §6166 Opportunity

§9.19 4. IRC §6166 Opportunity

Although publicly traded companies rarely are considered closely held businesses in common parlance, the estate tax deferral opportunity offered by IRC §6166 can apply to the shareholder of a publicly traded corporation if 20 percent or more of the voting stock of the corporation is included in the decedent's gross estate and that holding represents 35 percent or more of the adjusted gross estate. See IRC §6166(a)(1), (b)(1)(C)(i).

© The Regents of the University of California

III. PLANNING ALTERNATIVES DURING LIFETIME

§9.20 A. Nonvested, Compensatory Stock

An employee or director who receives nonvested stock as part of his or her compensation for services to the corporation may choose to recognize income immediately as a result of the election available under IRC §83(b). See §9.17. Unless the taxpayer files an election in accordance with Treas Reg §1.83-2 within 30 days after the stock is granted to the taxpayer (even though subject to restrictions), income will not be recognized until the stock becomes transferable or there is no longer a substantial risk of forfeiture. See Treas Reg §1.83-3(c).

PRACTICE TIP: Making a §83(b) election seems to offer a way to lower the effective tax on future appreciation when nonvested compensatory stock is granted. However, the employee needs to run the numbers before making the election. In the authors' experience, the costs of early exercise (*i.e.,* the taxes triggered by the election, plus either the lost income on the employee's funds used to pay the taxes or the interest charges on the funds borrowed for that purpose) can be quite high. This strategy should be adopted only if the stock has significant appreciation potential. Even in those cases, however, the employee must carefully weigh the added risk that the stock might not actually vest.

Nonvested compensatory stock is usually held in an account maintained in the corporate records rather than in certificate form. To exclude the stock from probate should the beneficial shareholder die before the stock vests, most deferred compensation plans allow the stockholder to identify a beneficiary to take in the event of death. Otherwise, the stock will most likely pass to the shareholder's estate, perhaps triggering a probate proceeding.

PRACTICE TIP: As with any other form of employee benefit, the beneficiary designation should be coordinated with the balance of the estate plan.

Once the stock vests (and the tax liability is paid), the shareholder usually can direct that it be transferred to an account with a brokerage firm or issued in certificate form. If a revocable living trust forms a part of the estate plan, the receiving account or certificate should be in the name of the trustee.

When the stock vests and the shareholder has the ability to dispose of it, the shareholder may choose to hold the stock. As with any stock, however, sale may be an attractive alternative, particularly if over-concentration is a concern. See §9.21. Because the stock's basis will have been stepped up to current market value on vesting, continuing to hold it after vesting will generally be an investment decision, not a tax-deferral play. Holding the stock must be weighed against the investment risks of an over-concentration in the stock.

© The Regents of the University of California

B. Restricted or Control Stock

§9.21 1. Sell Part to Diversify

The volatility of the public equity markets in recent years has led to increased concern about diversifying risk, particularly for those with concentrated holdings. The portfolio value of many individuals, trustees, foundations, and endowments has declined precipitously as a result of company or industry-specific risk, such as in the technology and telecommunication sectors. Others have experienced substantial, but not catastrophic, declines.

In the language of modern portfolio theory, these are "unsystematic" or "uncompensated" risks, and trustees may be particularly subject to criticism (and potential liability) for incurring these risks. See *e.g.,* Langbein, *The Uniform Prudent Investor Act and the Future of Trust Investing*, 81 Iowa L Rev 641 (Mar. 1996); Halbach, *Trust Investment Law in the Third Restatement*, 77 Iowa L Rev 1151 (Mar. 1992).

© The Regents of the University of California

a. Diversification Issues for Individual Investor

§9.22 (1) Holding Versus Selling Analysis

Diversification may be more complicated for tax-paying individuals and trustees than for large portfolio managers. Consider a prototypical business founder, Mr. Founder, who is a senior corporate executive or director with a concentrated position in restricted stock that also is control stock. His assets consist of residential real estate, an IRA, his company stock, and a small portfolio of publicly traded securities that he has acquired over a number of years. Although he may be quite a sophisticated investor, his plan for the future may be very simple. He plans to hold what he has and defer capital gains tax, unless a compelling reason arises to sell any of his stock. After he dies, he expects that his wife will liquidate virtually all of the company stock and reinvest in a broadly diversified portfolio of securities and index funds. His rationale is the simple, traditional one: "I can't afford to sell any of this stuff. If I do, the market will think that the company is in trouble *and* I'll have to pay too much tax."

Analytically, Mr. Founder compares (a) the expected value of his portfolio to his family after his death if he continues to hold the concentrated positions with (b) the expected value of a highly diversified portfolio if he sells the concentrated positions, pays capital gains tax, and reinvests the remaining proceeds. Mr. Founder may be troubled by the effect of volatility on his expected returns. He probably recognizes that there is much more risk in holding his concentrated position than in a diversified portfolio, but usually he is unable to quantify the effect of that intuition.

Although Mr. Founder cannot quantify the effect of volatility on his expected return as he considers whether to hold or diversify, modern computing power and the use of "Monte Carlo" simulation techniques provide a new analytic structure for decision-making. These statistical tools use thousands of simulations of multiple uncertain or random variables. The distribution of the expected results of holding versus diversifying assists in the choice between the two.

NOTE: Although Mr. Founder's estate planning lawyer may not be the appropriate person to perform a sophisticated financial analysis for Mr. Founder, having a basic understanding of the analytic approach can be useful when discussing lifetime alternatives with clients.

PRACTICE TIP: One way to focus Mr. Founder's attention on the risks of over-concentration is to ask him how much of his total wealth he would be willing to invest in the stock if his current net worth were all cash. It is the rare client who would elect to invest as much as his or her current exposure or more than 10 percent of his or her net worth in the stock. In fact, investment professionals will rarely invest even as much as 5 percent of a portfolio in a single stock.

If Mr. Founder is willing to make what statisticians call "equilibrium" estimates, state-of-the-art quantitative analysis allows him to consider the "expected return," "yield," and "standard deviation" of expected investment results of holding a concentrated position compared with selling, paying tax, and reinvesting in a diversified portfolio. For a single stock position, he might consider the expected return based on the expected performance of each of the stocks included in the S&P 500, determine the most likely (median) result for each hypothetical single stock position, and identify the range of results better than the worst 5 percent of the possible results. Or, he might consider a customized analysis that focuses only on his stock. In either situation, he might ask what is the minimum portfolio value that he can expect after 10 or 20 years at least 95 percent of the time.

As a basis for comparison, suppose Mr. Founder considers selling a concentrated stock position in which the basis is equal to 50 percent of fair market value, paying tax, and reinvesting in a diversified portfolio. Again, what is the most likely portfolio value and what is the minimum portfolio value after 10 or 20 years that he can expect at least 95 percent of the time?

Results will vary with the type of asset allocation selected for the diversified portfolio. However, provided that the majority of the after-tax proceeds is invested in equity-type securities over 10 years or more, the diversified portfolio usually outperforms the concentrated position in at least two critical areas. First, even after paying taxes at the outset, the "median" (or statistically most likely) case for the diversified portfolio is often better. More importantly, the worst 5-

percent case is often dramatically superior.

NOTE: Using different software and varying the assumptions will change the precise results; they will not change the underlying conclusion. Non-diversified positions are riskier than diversified ones. Research of this type provides the analytic basis for the Prob C §16048 generally applicable rule of diversification by trustees.

© The Regents of the University of California

§9.23 (2) Practical Considerations in Selling

In addition to tax and securities law considerations (see §9.24), if Mr. Founder decides to sell some restricted or control stock, there is the practical consideration of how to sell some or all of a concentrated position. Depending on the size of a block, the way in which it is sold can affect the market price and, hence, the amount of the gross proceeds. Some brokers have much more experience with block trades of restricted securities than others. Brokers may make an "agency" sale, in which the broker places a block with a buyer or buyers, or a "principal" sale, to a market maker or block positioner—including the brokerage firm itself. Each type requires experience in the marketplace.

Perhaps an example of how *not* to sell a significant block of securities will help. In one instance, a generally experienced trusts and estates lawyer solicited "bids" directly from three market makers in a particular security, hoping to ensure that the client would receive "fair market value" for the stock. The consequence of that attempt at competitive bidding was an immediate and substantial decline in the price of the stock, because each market maker anticipated an increase in the supply of stock available at the price bid by that market maker. At the risk of stating the obvious, a broker or securities lawyer experienced with block trades probably would not have suggested this approach.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.24 b. Securities Law Considerations in Selling

§9.24 b. Securities Law Considerations in Selling

Sales of a concentrated position by an individual investor are subject to the antifraud provisions of Exchange Act Rules 10b-5 and 10b5-1 (17 CFR §§240.10b-5, 240.10b5-1). See §9.4. Some investors use independent trustees of irrevocable trusts combined with 10b5-1 sales programs or blind trusts to add a layer of insulation against insider trading claims when selling restricted or control securities.

When the seller is an affiliate, Securities Act Rule 144 (17 CFR §230.144) constraints also apply (see §9.5), including:

- The 6-month minimum holding period for restricted stock of reporting companies (see §9.6);
- The 90-day public reporting requirement for the company (see §9.7);
- The manner of sale restrictions (see §9.9);
- The volume limits for both restricted and control stock (see §9.8); and
- The Rule 144 attribution rules (see §9.8).

Orders to sell restricted or control securities must be reported promptly on SEC Form 144. See §9.10. The minimum holding period and company reporting requirements also apply to sales by non-affiliates.

Exchange Act §§13(d) and 16(a) (15 USC §§78m(d), 78p(a)) usually require insiders to report on SEC Form 4, SEC Form 5, SEC Schedule 13D, and/or SEC Schedule 13G, as discussed in §§9.12-9.13. Finally, an insider must be careful not to purchase (or engage in a purchase-equivalent transaction) within 6 months before and after the sale, in order to avoid short-swing profits forfeiture under Exchange Act §16(b) (15 USC §78p(b)). See §9.12.

© The Regents of the University of California

2. Give Part to Charity

§9.25 a. Types of Charitable Gifts

An individual investor might give some restricted or control stock to public charities (including those with donor-advised funds) as a way to avoid paying tax on capital gains while satisfying philanthropic desires. Or, an investor might give to a private, grant-making foundation. In doing so, he or she probably would be substituting gifts of highly appreciated restricted or control securities for gifts of other assets to increase the amount by which the tax collectors subsidize charitable giving and, in effect, to diversify by reducing the relative size of a concentrated holding. In the authors' experience, the market's reaction to this type of diversification is generally more benign than an outright sale by the insider.

Often, a charitably inclined investor will make a sizeable charitable donation when undertaking a taxable selling program. The donation creates a legitimate tax shelter for gains recognized in the selling program aimed at diversifying the investor's holdings. Because the gains increase the seller's adjusted gross income, the seller will have a larger appetite for charitable deductions in the year of the sale. See IRC §170(b).

PRACTICE TIP: Consideration must also be given to the effect the increase in adjusted gross income (AGI) will have on the phase-out of itemized deductions. If 3 percent of the additional AGI exceeds 80 percent of the client's other itemized deductions, then some portion and perhaps as much as 80 percent of the charitable deduction could be lost. See IRC §68(a). This risk is perhaps most problematic in states with low or no income taxes. In high-tax states (like California), the additional AGI is usually accompanied by a comparable increase in state income tax deductions, which should be sufficient to absorb any additional phase-out adjustments under IRC §68(a).

Beyond outright gifts, charitable remainder unitrusts have become a standard technique to dispose of highly appreciated assets that benefits both the donor and charity. The actuarial value of the charitable remainder interest can be limited to 10 percent of the value of restricted securities (see IRC §664(d)(2)(D)), which may be considerably less than the taxes the investor would pay in an outright sale.

Although experienced planners seldom draft straight charitable remainder unitrusts for gifts of restricted or control securities because of the potential for delay in consummating a sale, some have drafted charitable remainder unitrusts with so-called "flip" provisions in recent years. Under these arrangements, disposing of restricted or control stock at the end of a predefined period of time triggers a shift from a payout limited to the lesser of the unitrust amount and net income to a requirement to pay a straight unitrust amount. See generally Treas Reg §1.664-3(a)(1)(c)-(d).

More often, however, experienced planners encourage clients to create unitrusts with a net income limitation, often with a so-called make-up provision, and the allocation of post-contribution gains to income to facilitate investment in a growth-oriented portfolio. Frequently in this context, trustees invest in a way that defers significant payouts for some period to permit pre-tax growth of trust assets that will fund larger payouts later—larger payouts to both the income beneficiary and the charity. Often, trustees invest in a way that is intended to provide a means to fund a make-up payment to the income beneficiary in the future.

EXAMPLE: A trustee might invest in interests in a Delaware statutory trust that does not generate any fiduciary accounting income but that hopefully will produce a gain on sale to fund a make-up payment later. Similarly, a trustee may invest in a group of stocks that do not pay dividends, as a way to provide a "spigot," the use of which is intended to benefit both the investor and the charitable remainder beneficiary by permitting one or more periods of growth without current distribution.

Finally, an investor might give stock to the trustee of a non-grantor charitable lead trust if he or she:

- Believes the stock will appreciate faster than the applicable rate under IRC §7520 and wants to transfer the "excess" appreciation to a noncharitable beneficiary; or

- Wants to make charitable gifts for which he or she otherwise could not enjoy a current income tax deduction because of the IRC §170(b) annual deduction limitations.

In either of these situations, gain recognized by the trustee on sale or distribution in kind to a charity likely can be sheltered by the trustee's distribution deduction. See IRC §642(c)(1).

PRACTICE TIP: Charitable gifts of restricted or control stock must be carefully planned to minimize the potential for valuation discounts (due to the limits on transfer imposed by Securities Act Rule 144) and the potential loss of a fair market value deduction when the donee is a private foundation. See IRC §§170(e)(1)(B)(ii), (e)(5). One strategy approved by the IRS, involves an agreement between the donor and the charity that gives the charity the first right of sale under any combined volume limit that may apply to both under Rule 144(e)(3)(iii) (17 CFR §230.144(e)(3)(iii)). See IRS Letter Ruling 9734034. For a discussion of this technique, see Weigandt, *Charitable Giving without Fear of Death*, 54 USC Tax Inst Major Tax Plan ¶1106.5A (2002). Of course, now that the volume limits no longer apply to non-affiliates, this issue has diminished in importance. However, it continues to have vitality when the charity is considered an affiliate in its own right.

© The Regents of the University of California

§9.26 b. Reporting Requirements for Charitable Gifts

Although no filing is required under Securities Act Rule 144 as a result of a charitable gift (see 17 CFR §230.144(h)), an insider must report any gift to charity or a charitable split-interest trust under Exchange Act §16(a) on SEC Form 5 (17 CFR §§240.16a-3(f)(1)(i), 240.16b-5; see §9.12) or under Exchange Act §13(d) if the investor owns more than 5 percent of a class of publicly traded voting stock and was not required to report under §16 (17 CFR §240.13d-1; see §9.13). Assuming that a gift to charity or a gift of any non-retained interests in a charitable trust is a bona fide gift, short-swing profit penalties should not apply. See 17 CFR §240.16b-5. Therefore, a donor-insider need not be concerned with matching the gift with any other transaction.

After a gift to a charitable trust, the donor-insider must continue to report the trust's transactions for §13(d) purposes if he or she acts as a trustee or otherwise directly or indirectly participates in voting or investment decisions with respect to the stock. See 17 CFR §240.13d-3(a)-(b).

The donor-insider may have to continue to report the trust's transactions under the provisions of §16(a) as well. If the donor acts as trustee (or otherwise holds a power to vote or dispose of the stock), he or she will continue to have beneficial ownership of the shares. See 17 CFR §240.16a-8(a)(2)(i). Also, transactions in the shares by the charitable trust may be reportable by the donor or subject the donor to short-swing profits forfeiture. For example, they will be attributed to any trustee who is also a beneficiary or whose immediate family includes a beneficiary. See 17 CFR §240.16a-8(b)(2). For this purpose, however, a remainderman is not considered to have a beneficial interest if he or she has no investment control. 17 CFR §240.16a-8(c). Finally, the transactions will be attributed to a beneficiary who has voting or investment control. See 17 CFR §240.16a-8(b)(3).

The short-swing profit forfeiture rules of §16(b) apply to match trust transactions with personal ones if the insider (or any other trustee or beneficiary) has a §16(a) reporting requirement as a result of the attribution rules. See 17 CFR §240.16a-8(d).

PRACTICE TIP: As a practical matter, insiders almost always select independent trustees for charitable remainder trusts to reduce this §16(b) risk. However, this approach may be reconsidered if there is an intent to pay the unitrust or annuity amount in stock of the insider's company. These payments could be treated as sales by the trust and purchases by the donor-beneficiary under §16(b). Such a result might be avoided by having the donor act as trustee because all trust stock would then be considered the trustee's stock under the §16 attribution rules. See *Munger, Tolles & Olson,* SEC No-Action Letter (Dec. 10, 1991) 1991 SEC No-Act Lexis 1347.

After an outright gift to a private foundation or public charity, a donor may be required to continue to report the foundation's or public charity's holdings on his or her §13(d) filing if he or she serves on the governing body and holds or shares the power to vote or dispose of the stock. In that case, the donor will continue to report the charity's transactions in the stock for §16(a) purposes as well. See 17 CFR §240.16a-1(a)(1). Because of the legal prohibitions against self-dealing and private benefit (see IRC §§4941, 4958), however, the donor is unlikely to enjoy any "pecuniary interest" in the stock after donation. Consequently, it is unlikely that the donor will be exposed to short-swing profit liability under §16(b) as a result of the foundation or charity's transactions. See generally 17 CFR §240.16a-1(a)(2); *Sarkowsky Found.,* SEC No-Action Letter (Feb. 6, 1990) 1990 SEC No-Act Lexis 187. But see SEC Release No. 34-18114 (Sept. 23, 1981).

© The Regents of the University of California

§9.27 c. Constraints on Charitable Entities

The securities law considerations discussed in §§9.3-9.14 apply to directors and trustees of public charities, private foundations, and charitable trusts. The most common considerations are the constraints imposed by Securities Act Rule 144. See §§9.5-9.10. The Rule 144(d) 6-month holding period for restricted securities applies to the stock held by the donee, but will be determined by "tacking" on to the donee's holding period the period that the securities were held by the donor. See 17 CFR 230.144(d)(3)(v).

NOTE: The fact that a transfer may be treated as a constructive sale for income tax purposes (*e.g.,* when a charitable lead trust distributes stock in kind to the charitable income beneficiary) should not disturb these results. See *Service Merchandise Co.,* SEC No-Action Letter (Jan. 11, 1988) 1988 SEC No-Act Lexis 1.

If an investor transfers control stock to charity, sales by the charity will not be restricted by volume limits, assuming that the charity is not an affiliate in its own right. However, these sales will affect the donor's volume limits for at least a 6-month period after transfer. See 17 CFR §230.144(e)(3)(iii). In effect, they reduce the number of shares that the donor can sell during the applicable 3-month period.

Whether the charity, foundation, or trust itself is treated as an affiliate and whether it remains subject to Rule 144's provisions restraining the sale of control securities after the expiration of the initial 6-month period will depend on the facts and circumstances of the situation. For example, if a donor-affiliate is the trustee of a charitable remainder trust *or* if a donor-affiliate and members of his or her family sharing the donor's residence (as a group) hold at least a 10-percent beneficial interest in the trust (even if there is an independent trustee), the SEC takes the position that the donor and the trust "entity" are the same "person" for the purposes of Rule 144's volume limits. See 17 CFR §230.144(a)(2)(ii); *Riordan & McKinzie*, SEC No-Action Letter (May 5, 2000) 2000 SEC No-Act Lexis 615. Presumably, sales of shares held by the trust will be aggregated with the donor's shares to determine the amount of stock the trust can sell until the donor ceases to be an affiliate.

The SEC has ruled on several occasions, however, that a private foundation is not the same "person" as the donor even though the donor and his or her family control the foundation. The critical issue seems to be the lack of a financial interest by the donor in the donated securities. (Although in most cases this probably means that the foundation is not an affiliate, affiliate status is a facts and circumstances determination on which the SEC will not rule.) Thus, the foundation will be free to sell after the 6-month holding period has elapsed (including the holding period of the donor), unless the foundation is considered an affiliate in its own right. See *R.E. Turner & The Turner Found*., SEC No-Action Letter (Mar. 19, 1993) 1993 SEC No-Act Lexis 489; *The Gap, Inc*., SEC No-Action Letter (Sept. 16, 1992) 1992 SEC No Act Lexis 928. Also, in such a case, the Rule 144 volume limit would be applied to the donor without regard to any sales by the foundation. See, *e.g., P. Michael Coleman,* SEC No-Action Letter (Dec. 29, 1994) 1994 SEC No-Act Lexis 860.

If the percentage ownership by the charity, foundation, or trust is large enough or if an insider is an officer, director, or trustee of such entity, then §§16(a) and 13(d) may also apply. Of course, the antifraud provisions of Rule 10b5-1 may also apply if the officer, director, or trustee of the entity has any material, nonpublic information.

© The Regents of the University of California

§9.28 3. Transfer Part to Family

A holder of restricted or control stock may want to give a portion of the holding to family members or other taxable recipients if the shareholder (a) otherwise is disposed to make a gift, and (b) either believes the stock is likely to appreciate in value faster than other assets or does not want to increase her or his concentration of assets in the company by giving other assets (or both). The motivation for the gift usually is to shift the opportunity for future appreciation to the donee. Classic examples include gifts of stock in a start-up business, a business in a consolidating industry that may be acquired, or a business likely to "go public." Obviously, the farther in advance of a "transition event" a gift is made, the more likely the gift will shift opportunity effectively.

NOTE: Although not as common in the authors' experience, giving stock of a company in substantial financial distress is sometimes perceived as a gift that conveys upside potential at little transfer tax cost. In fact, shares of a promising company taking a temporary market beating are ideal candidates for lifetime transfer. The lower value translates into a smaller amount of gift tax or smaller use of unified credits. Moreover, these "costs" can be eliminated altogether by funneling the gift through a "zeroed-out" GRAT. See §§9.31-9.31D.

In any transfer within the family, whether by gift or sale, valuation will be an important issue. A threshold question is how any Rule 144 restrictions are to be taken into account for this purpose. In the Ninth Circuit at least, it is clear that the relevant restrictions are those that applied to the decedent just before death, not to the recipient. The fact that the estate (in this case, a non-affiliate) would not have been subject to Rule 144 volume limits is irrelevant. See *Estate of McClatchy v Commissioner* (9th Cir 1998) 147 F3d 1089.

Although a sampling of the cases dealing with the valuation of restricted stock yields no consistent pattern of discounts, the methodology employed focuses on the actual disposition alternatives available in the particular case. The three valuation methods to estimate fair market value are a secondary public offering of the shares, a private sale, and an open market sale compliant with Rule 144 volume limits ("dribble out"). To these can be added a possible redemption by the issuer (really just a special form of private sale). See *Trust Servs. of Am., Inc., v U.S.* (CD Cal 1988) 88-1 USTC ¶13,767, 71A AFTR2d 5002, aff'd in part and rev'd in part on other grounds (9th Cir 1989) 885 F2d 561; *Estate of Georgina T. Gimbel,* TC Memo 2006-270. Sometimes the amount of the discount is stipulated, but if determined by the court, discounts have ranged from as low as 14 percent to as high as 33 percent. Compare *Estate of Georgina T. Gimbel, supra,* with *Estate of Saul R. Gilford* (1987) 88 TC 38.

© The Regents of the University of California

§9.29 a. Outright Gifts

Contingent rights to nonvested stock usually are not transferable. Restricted or control stock often is, however, and any gift or sale of the stock of a public company by an insider usually must be disclosed in the appropriate filings on SEC Form 4 or 5 (see §9.12) and/or SEC Schedule 13D or 13G (see §9.13). Reporting is not required if the donor retains the power to vote or dispose of the stock, although the retention of such powers could undermine the transfer tax benefits of the gift in many cases.

For Exchange Act §13(d) purposes, reporting is required if there is a material change in the donor's direct and indirect voting and investment control. 17 CFR §240.13d-2(a).

For Exchange Act §16(a) reporting purposes, securities held by a person's "immediate family" sharing the same household are treated as if they were beneficially owned by the insider. 17 CFR §240.16a-1(a)(2)(ii)(A). For this purpose, immediate family means any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptees. 17 CFR §240.16a-1(e). Consequently, both the initial gift and a subsequent transfer by the donee may have to be reported by the donor.

Although §16(a) reporting requirements apply, gifts and inheritances are not subject to the short-swing profit forfeiture rule of §16(b). See 17 CFR §240.16b-5. Subsequent sales by donee relatives sharing the same household can be matched to sales by the donor, however, because the insider is considered to have an indirect pecuniary interest in the securities held by these relatives. See 17 CFR §240.16a-1(a)(2)(ii)(A).

Bona fide gifts do not have to be reported on SEC Form 144, because Rule 144 applies only to sales of stock in the public markets. See Cafferata and Maldonado, *CRT.com: Structuring a Charitable Remainder Trust for the High Tech Insider*, 4 J of Gift Plan 19, 20 (4th Q 2000); 17 CFR §230.144(h)(2).

For purposes of the holding period requirements for restricted securities, stock acquired by gift from an affiliate is deemed to have been acquired by the donee when it was acquired by the donor. See 17 CFR §230.144(d)(3)(v). Consequently, if the donor-affiliate has held the stock for more than 6 months before making the gift, the non-affiliate donee will be able to sell the stock immediately, provided that the issuer satisfies the company reporting requirements. 17 CFR §230.144(b)(1)(i).

Any donee, however, who is a relative sharing a household with the affiliate is tainted by the affiliate status of the donor. The same is true of any trust, estate, or other entity in which the affiliate and his or her relatives sharing the same household collectively hold at least 10-percent beneficial interest or act as trustee or executor. See 17 CFR §§230.144(a)(2)(i), (ii). Accordingly, such sales will be subject to the affiliate donor's volume limits, manner of sale, and filing requirements.

In addition, sales of restricted and control securities by non-affiliate donees usually are aggregated with sales by the donor for at least 6 months after the gift.

Assuming that the 6-month holding period has been satisfied, sales by the donee are not affected. Those sales will, however, count against the volume limits applicable to the donor's sales. See 17 CFR §230.144(b)(1)(i), (e)(3)(iii).

© The Regents of the University of California

b. Transfers to Trusts

§9.30 (1) IRC §2036 Problem

Sometimes transfers of restricted and control stock are made to trusts for the benefit of family members and other taxable beneficiaries as a way to preserve "concentrated" voting power of the stock. Reservation of voting power by the donor will cause the stock to be included in the donor's estate under IRC §2036(b) and, depending on the terms of the trust, may cause inclusion under §§2036(a) and 2037 as well. Consequently, in these cases, consideration should be given to naming a person or institution other than the donor as trustee.

© The Regents of the University of California

§9.31 (2) Transfer to GRAT

To avoid the valuation uncertainties of restricted and control securities and reduce exposure to gift tax, shareholders sometimes give restricted and control stock to grantor-retained annuity trusts (GRATs). During the term of the GRAT annuity, there should be relatively little concern about estate includability as a result of retained voting control. The assets will be included in the donor's estate under IRC §2036(a) anyway if the donor dies during the annuity period because of the retained annuity rights. Consequently, some donors will act as trustee of a GRAT funded with restricted or control securities until the end of the annuity period. In addition, as discussed in §9.31C, if the donor-insider acts as trustee, this may reduce his or her exposure to short-swing profit forfeiture under Exchange Act §16(b) (15 USC §78p(b)) with respect to any stock that comes back to the donor via the annuity payments.

Once the annuity term ends, however, it is critical for the donor to step down in favor of another person or institution. Otherwise, the donor's continued service as trustee will expose the trust to estate tax inclusion under IRC §2036(a) (and perhaps under IRC §2036(b) as well). Moreover, because the donor no longer has a beneficial interest in the trust, an independent trustee may reduce the donor's §16(b) profit-forfeiture exposure. Reporting and short-swing profits exposure relative to the trust's shares would be limited to the trust, unless the donor or a beneficiary who is a member of the donor's family sharing the same household has or shares investment control with respect to the stock. See 17 CFR §§240.16a-1(a)(2)(ii)(A), 240.16a-8(b), (d).

PRACTICE TIP: It is often the case that a GRAT will grant the donor the power to substitute assets of equivalent value for assets held by the trust. Such power, if it is exercisable in a nonfiduciary capacity, insures that the GRAT is wholly a grantor trust and that status should continue after the annuity period ends. See IRC §675(4)(C). See also IRS Letter Ruling 200709011 (grantor trust status depends on actual administration of trust). It also provides a practical way to protect gains during the annuity term because the grantor can take back the stock in return for a less volatile asset (*e.g.,* cash). Although this would constitute a sale by the GRAT, no gain or loss is recognized for income tax purposes when a grantor trust either sells or buys an asset from its grantor. See Rev Rul 85-13, 1985 Cum Bull 184. However, the inclusion of a substitution power raises risks under Exchange Act §16 because the right to acquire the shares can be both a beneficial interest and a pecuniary interest in the shares. See 17 CFR §§240.13d-3(d)(1), 240.16a-1(a)(2)(i). As a result, even after the donor steps down as trustee (*i.e.,* when the annuity period ends), the right of substitution may still tie the shares to the donor for §16 purposes, or if not, any purchase under the substitution right will likely be matchable to any sales by the donor within 6 months before or after the purchase (see §9.31C). Accordingly, advisors may want to consider in such cases other provisions to continue grantor trust status for the subsequent period (*e.g.,* the power to lend to the grantor without adequate interest or security under IRC §675(2)). Relying on other provisions could also mitigate IRC §2036(b) risks because the right to reacquire the stock could be treated as the right to vote it. See Prop Treas Reg §20.2036-2(c).

© The Regents of the University of California

§9.31A (a) Rule 144 Requirements

The initial transfer to the GRAT is not reportable under Securities Act Rule 144 if it constitutes a bona fide gift, since Rule 144 applies only to sales of stock in the public markets. See 17 CFR §230.144(h)(2). The GRAT must hold the stock for at least 6 months before any sales, but its holding period includes the period that the stock was held by the grantor. If both the GRAT and the donor are non-affiliates, the volume limits will not apply. 17 CFR §230.144(d)(1), (d)(3)(v).

However, if the grantor is an affiliate, the GRAT will also be an affiliate. This will be true regardless of who acts as trustee, as long as the remaining beneficial interest in the GRAT of the grantor and members of the grantor's family living in the same household is at least 10 percent. See 17 CFR §§230.144(a)(2)(ii). As a result, a GRAT funded by an affiliate will usually be subject to the grantor's volume limits, manner of sale, and reporting requirements under Rule 144, regardless of the period it is deemed to have held the stock.

Distribution of the stock back to the grantor in satisfaction of an annuity payment or to another beneficiary on expiration of the annuity period should not be reportable for Rule 144 purposes, because again there is no sale. Rule 144 aggregation after the annuity term ends will depend on the facts and circumstances involving the grantor, the remainder beneficiary, or any continuing trust. For example, if the GRAT remainder is paid to the grantor's children or a trust for their benefit and the children still reside with the grantor, such stock may continue to be subject to the grantor's volume limits, manner of sale, and reporting requirements.

© The Regents of the University of California

§9.31B (b) Section 13(d) Requirements

If the grantor's voting or investment control changes materially, the initial transfer to the GRAT may have to be disclosed on SEC Schedule 13D or SEC Schedule 13G. A payment in kind to satisfy the annuity may trigger additional Exchange Act §13(d) reporting, as may termination of the annuity period. By contrast, a change may not be reportable under §13(d), if there is no change in voting or investment control. Generally, transfers between the GRAT and the grantor during the annuity period will not be reportable if the grantor is the GRAT trustee. Otherwise, reporting under §13(d) will depend on the powers, if any, retained by the grantor with respect to the GRAT's assets. See 17 CFR §240.13d-3(a).

© The Regents of the University of California

§9.31C (c) Section 16 Requirements

The initial transfer to the GRAT likely will not be a reportable event for Exchange Act §16(a) purposes (see 17 CFR §§240.16a-8(c), 240.16a-13) and is unlikely to be a §16(b) prohibited short-swing trade (see 17 CFR §240.16b-5).

The obligation to report stock distributed back to the grantor under §16(a) depends on whether the distribution effects a change in pecuniary interest. For example, if as is often the case the grantor is the GRAT's trustee, no report should be required because the distribution merely converts the grantor's indirect ownership to direct ownership. See *Peter J. Kight,* SEC No-Action Letter (Oct. 16, 1997) 1997 SEC No-Act Lexis 946; 17 CFR §240.16a-13. On the other hand, if the GRAT has an independent trustee (and the grantor does not otherwise control the voting or disposition of the stock), it is likely that the distribution will have to be reported as an acquisition by the grantor. In addition, the trust will have to report its disposition if it holds more than 10 percent of the shares in its own right. See 17 CFR §240.16a-8(a)(1), (b).

In cases in which the distribution must be reported, an argument can be made that the distribution is a sale by the GRAT to the grantor because the distribution satisfies a dollar obligation that the GRAT owes to the grantor. Certainly, that is the way that it would be characterized for income tax purposes, although any tax on the deemed sale would be ignored if the GRAT were a grantor trust in its entirety. See Rev Rul 85-13, 1985-1 Cum Bull 184. However, the SEC has indicated that the tax treatment of a trust distribution is irrelevant, at least for purposes of Rule 144. See *Service Merchandise Co.,* SEC No-Action Letter (Jan. 11, 1988) 1988 SEC No-Act Lexis 1, in which the deemed sale treatment of a payment in kind to satisfy a distribution obligation of a charitable lead trust was ignored in determining the distributee's holding period under Securities Act Rule 144(k) (17 CFR §230.144(k)).

Support can also be found in *Morales v Quintiles Transnational Corp.* (SD NY 1998) 25 F Supp 2d 369. Nominally, the court in *Morales* held that a distribution to the grantor (by a GRAT having a co-trustee who was not the grantor) constituted a sale to the grantor under Exchange Act §16(b) in exchange for the value of the stock at the time of the distribution. *Morales* is distinguishable from *Kight,* which reached a contrary result, because *Morales* involved a transfer under the grantor's discretionary right to substitute assets of equivalent value, rather than an annuity payment. In the order denying reconsideration in *Morales,* the court distinguished *Kight,* noting that the defendant had exercised a discretionary right that could create an opportunity for abuse, whereas the distribution in *Kight* was not discretionary and therefore did not create such an opportunity. 25 F Supp 2d at 371.

Potentially more troubling is a series of district court opinions dealing with stock of Infospace, Inc., also involving GRATs and §16(b). See *Dreiling v Jain* (WD Wash 2003) 281 F Supp 2d 1234; *Dreiling v Kellett* (WD Wash 2003) 281 F Supp 2d 1215. The specific transactions at issue, however, again involved transfers from the trusts to the grantors other than annuity payments (in these cases, unauthorized invasions of GRAT assets). In both cases, the court held that the transfers were sales to the grantors for purposes of §16(b) because they were voluntary transactions that were ripe for abuse. Most disturbing is the court's decision that these sales were for no consideration, resulting in disgorgement of the entire proceeds from subsequent sales by the grantors within the proscribed 6-month period. Although this case law does give one pause in planning GRATs for insiders, the cases seem to involve aberrant situations with special facts.

PRACTICE TIP: Careful advisers will plan their GRAT transactions to avoid the pitfalls highlighted by such cases. Consideration should be given to the following:

- Clearly, there is an advantage to having the grantor serve as trustee. Under the authority of *Kight,* which still appears as of this writing to be good authority, contributions into, and annuity payments out of, a GRAT that has the grantor as trustee do not trigger §16(a) reporting or §16(b) short-swing profits issues.
- The grantor should be very careful in exercising any right of substitution. Substitution should not be allowed unless there are no sale transactions within 6 months before the substitution that can be matched with this potential purchase, and unless the grantor and all those whose transactions are attributed to the grantor are willing to abstain from any transactions that might be considered sales under Rule 16(b) during the 6 months

following the substitution. In addition, the mere existence of a right of substitution can cause problems if the trust engages in sales or purchases. The right of substitution can cause beneficial and pecuniary interest in the shares to be attributed to the grantor. See 17 CFR §§240.13d-3(d)(1), 240.16a-1(a)(2)(i).

NOTE: Some practitioners have also expressed concern about potential insider trading penalties in connection with in-kind annuity payments by GRATs. Specifically, they are concerned with the flexibility on the distribution date provided by the 105-day rule of Treas Reg §25.2702-3(b)(4). If the insider-trustee holds material, nonpublic information during this period, there is a risk that he or she could be accused of picking a distribution date within the 105-day window that takes advantage of such information. Accordingly, in such situations, it may make sense to require distributions to be made on the designated distribution date or fix the number of shares to be distributed during the 105-day period by reference to the share value on the designated distribution date. Part of the confusion stems from the fact that the GRAT regulations provide no guidance on the value to use in determining the number of shares to distribute during the 105-day window. Should it be the value on the actual payment date or the date the payment became due? The authors' position is that the latter is both safer (because there is no room for manipulation by the insider) and perhaps more consistent with the intent of the provisions (because the donor enjoys the benefits and burdens of the distributed property starting on the annuity due date).

© The Regents of the University of California

§9.31D (d) After GRAT's Annuity Term

After the GRAT's annuity term ends, usually either the GRAT continues as an irrevocable trust with the remainder beneficiaries moving up to become the current beneficiaries, or the remaining assets are distributed to the remainder beneficiaries or to other trusts for their benefit. In either case, if the grantor has been serving as trustee, his or her term will usually end in favor of a successor who is neither the grantor nor the grantor's spouse. These events trigger potential issues under Securities Act Rule 144 and Exchange Act §§13(d), 16(a), and 16(b):

- *Rule 144:* If the grantor is an affiliate and the trustee and beneficiaries do not live with the grantor, the change in trustee will likely cause the trust no longer to be treated as an affiliate. If the trust's or a beneficiary's holding period for the stock (including the donor's holding period) is at least 6 months, the change in trustee could potentially allow the trust or beneficiary to sell shares freely 3 months later. See 17 CFR §230.144(a)(b)(1)(i).
- *Section 13(d):* If the grantor acted as trustee or otherwise held investment or voting control over the stock, termination of that role or distribution of the stock will trigger a change in beneficial ownership under Rule 13(d) and require an amendment to the grantor's 13D or 13G filing, provided that the remaining stock in the GRAT constitutes at least 1 percent of the particular equity class. See 17 CFR §240.13d-2(a). However, it is not unusual for any trust succeeding to the remainder interest to be a grantor trust for income tax purposes. Grantor status is often achieved by having the grantor retain the right to substitute assets of equivalent value for the trust's assets. See IRC §675(4)(C). The retention of such a power may obviate the need for a Rule 13(d) filing, because the retained power may constitute control over the disposition of the stock. See 17 CFR §240.13d-3(a), (d)(1).
- *Sections 16(a) and 16(b):* Because of the complexity of the §16 attribution rules, the grantor's exposure to reporting requirements and short-swing profits penalties with respect to the GRAT stock after the annuity term ends depends on a number of factors. If the grantor no longer has any investment or voting power in the stock, the grantor will be treated as having disposed of the stock by way of gift. See *Peter J. Kight,* SEC No-Action Letter (Oct. 16, 1997) 1997 SEC No-Act Lexis 946. Sales of such stock should not be matchable with the grantor's purchases. See 17 CFR §§240.16a-1(a)(1), 240.16a-5(a). However, the grantor will continue to be treated as the owner, if he or she continues to have a pecuniary interest in the stock, *e.g.,* if the distributees are members of his or her immediate family sharing a common household or the grantor continues to hold a power to substitute assets of equivalent value for the stock. See 17 CFR §§240.16a-1(a)(2)(i), (a)(2)(ii)(A), 240.16a-8(a)(2)(i). Whether the trust or beneficiaries are subject to reporting and short-swing profits provisions for the stock received or held for their benefit after the annuity term ends usually depends on whether they hold more than 10 percent of the stock (applying the §16 attribution rules). A beneficiary could, however, also be exposed by virtue of his or her position as an officer or director of the company.

NOTE: There could be issues under IRC §2036(b) as well, if the grantor serves as trustee and then dies within 3 years after the remainder is distributed. See IRC §2036(b)(3).

© The Regents of the University of California

§9.32 c. Installment Sales to Individuals or Trusts

In addition to making gifts, holders of restricted and control securities may want to sell them to family members on terms and conditions not generally available. For example, restricted and control securities may be sold on an installment basis to individuals or to trusts for their benefit. Common terms might be a modest down payment and a note with interest at the lowest rate permissible to avoid the imputed interest rules of IRC §7872.

NOTE: An issue that arises on such a sale to an individual or entity (other than a sale by the grantor to a grantor trust) is whether the sale will qualify for installment sale treatment under IRC §453. Ordinarily, the sale of publicly-traded securities for an installment note does not qualify for such treatment. See IRC §453(k)(2). However, are securities subject to Rule 144 restrictions on transfer "securities which are traded on an established securities market" for purposes of IRC §453(k)(2)? IRS Letter Ruling 9803009 answers this question in the negative. In the ruling, the IRS concluded that stock subject to Rule 144 volume limits was not considered tradable on an established exchange for purposes of IRC §453(k)(2). Accordingly, a deferred payment sale of such stock qualifies for installment sale treatment.

Oftentimes, installment sales are made to "defective" grantor trusts so that there is no gain recognition when the stock is sold to the trustee (or taxable income interest triggered by the ensuing payments on the note) and so that dividends received and gain realized when the trustee sells the stock will be taxable to the donor under the provisions of IRC §§671-677. See Rev Rul 85-13, 1985-1 Cum Bull 184. The question is whether such intrafamily sales make sense for restricted or control stock.

Because intrafamily sales are not made in the public securities markets, Securities Act Rule 144 does not provide an exemption to the generally applicable registration requirements. Rather, a combination of the exceptions provided by Securities Act §4(1) (transactions by persons other than an issuer, underwriter, or dealer) and §4(2) (transactions by issuers not involving public offering) (15 USC §77d(1)-(2)), commonly referred to as a "Section 4(1-1/2) exemption," often applies. There are no SEC rules or specific guidance for this exemption, but it is commonly recognized in practice. The principal concern is that the shareholder (even if not an affiliate) not act as an underwriter, so the focus is on the purchaser's sophistication and access to information, the number of people involved in the purportedly private transaction, and the selling shareholder's holding period. See generally Financing and Protecting California Businesses §§6.27-6.30 (Cal CEB 2006).

Although Rule 144 will not apply to the initial sale, the application of Rule 144 to subsequent sales by the purchaser presents significant challenges in using these strategies to move restricted or control stock by intrafamily sales. First, despite the literal language of Rule 144(d)(3)(vi) (17 CFR §230.144(d)(3)(vi)), which purports to allow a trust that "acquired" restricted stock from a settlor-affiliate to tack the settlor's holding period to its own, the SEC interprets this provision as applying only to gifts in trust. See SEC Release No. 33-6099 (Aug. 2, 1979) (Question 31), 1979 SEC Lexis 968. Consequently, the holding period of a trust that purchases restricted stock from the settlor-affiliate begins with the trustee's purchase. At a minimum, this means that a non-affiliate trust cannot sell the purchased shares for 6 months after the purchase.

More importantly, if the consideration for the purchase is an installment note, it is likely that the 6-month holding period will not begin until the note is fully paid. Only when the note is fully recourse to the buyer and is secured by other assets at least equal in value to the purchased stock can the holding period begin with the purchase. Even then, the note must be paid in full before the sale of the restricted stock. See 17 CFR §230.144(d)(2).

Technically, the purchaser's sales are aggregated with the seller's sales for purposes of the donor's volume limits for 6 months after the gift (see 17 CFR §230.144(e)(3)(iv)), but this is largely a moot issue because the buyer will not be able to sell during this period, as noted above. Aggregation will continue after the 6-month period if the donor and the trust are treated as the same person under the Rule 144 attribution rules or if the purchaser (including a trust) is an affiliate in its own right. See 17 CFR §230.144(a)(1)-(2).

The initial sale to the trust likely is reportable under Exchange Act §§16(a) and 13(d) as well, because voting and

investment power are likely to change at the point of sale. See 17 CFR §§240.13d-3(a), 240.16a-1(a)(1). However, no §13(d) reporting is required unless the change involves at least 1 percent of the particular equity class. 17 CFR §240.13d-2(a). Continued reporting by the seller may also be required because of the family attribution rules or because the grantor holds a power to substitute assets of equivalent value. See 17 CFR §§240.13d-3(d)(1), 240.16a-1(a)(2)(ii)(A), (E), 240.16a-8. A subsequent sale by the trust may be reportable, depending on the facts and circumstances. Section 16(b)'s profit-forfeiture rule applies to the initial sale to the trust by the insider and may apply to a subsequent sale by the trust, depending on the facts and circumstances. On installment sales to defective grantor trusts, see Drafting California Irrevocable Trusts, chap 3 (3d ed Cal CEB 1997).

NOTE: Both gifts and sales raise marketability and blockage valuation issues similar to those discussed in §9.18 in the postdeath context.

© The Regents of the University of California

§9.33 d. Contributions to Limited Partnerships or Limited Liability Companies

Sometimes, restricted and control securities are contributed to a limited partnership or limited liability company (LLC) in return for 100 percent of the ownership interests in the entity, a portion of which the owner then gives or sells to family members or trusts for their benefit. The initial contribution is not reportable for Rule 144 purposes, because these transactions are not sales in the public markets.

The question, however, is how Securities Act Rule 144 applies to subsequent transactions by the partnership or LLC. As noted in §9.32, it is likely that the transfer (whether contribution or sale) to the partnership or LLC will start a new Rule 144 holding period, since none of the "tacking" rules will apply. See 17 CFR §230.144(d).

NOTE: The SEC has ruled that the transfer of restricted stock to a *corporation* for 100 percent of its stock qualifies for tacking, although the specific authority under Rule 144 is not identified. See SEC Release No. 33-6099 (Aug. 2, 1979) (Question 33), 1979 SEC Lexis 968. The reasoning is that there is no shift in economic risk. By analogy, this holding could possibly extend to a transfer to a single-member LLC, although the authors could find no authority for this proposition. But even assuming that this reasoning applies by analogy to a single-member LLC, any subsequent transfer of interests in the LLC shifts economic risk, and undermines the analogy.

Moreover, if the stock is sold to the entity for an installment note, this new holding period will not begin until the note is paid in full, unless the note is a recourse obligation fully secured by assets other than the stock. See 17 CFR §230.144(d)(2). Also, if the transferor is an affiliate, the transferor and the transferee entity will be treated as one person for purposes of the volume limits for as long as the affiliate and members of his or her family hold at least 10 percent of the entity's equity. See 17 CFR §230.144(a)(2)(ii)-(iii). Consequently, Rule 144 reporting requirements and the transferor's volume limits may apply to the entity's sales in the public markets for a considerable period after it acquires the stock.

The initial transfer to the entity is not an Exchange Act §13(d) reporting event unless investment or voting control changes, and it may not be an Exchange Act §16(a) reporting event. As long as the transferor retains control over the actions of the transferee entity's voting or investment decisions with respect to the stock, there should be no change of beneficial ownership that would trigger §13(d) or §16(a) reporting. See 17 CFR §§240.13d-3(a), 240.16a-13. The entity itself will not be required to report its acquisition of such stock under those sections unless its ownership crosses the requisite 5-percent or 10-percent threshold.

Subsequent transfers of interests in the entity may, however, trigger reporting issues. Reporting by the transferor otherwise subject to §13(d) or §16(a) will be required if the transfer of interests in the entity shifts control over the voting or investment decisions with respect to the stock and, in the case of §13(d), involves more than 1 percent of the equity class. See 17 CFR §§240.13d-3(a), 240.13d-2(a), 240.16a-1(a)(2)(iii). See also *Widett, Slater & Goldman, P.C.*, SEC No-Action Letter (Mar. 25, 1992) 1992 No-Act Lexis 392. However, reporting by the entity and those who gain the necessary control will be required only if their beneficial ownership exceeds the requisite 5 percent or 10 percent threshold.

NOTE: Decisions that call into question the viability of transfers to family partnerships to reduce transfer taxes by garnering minority and illiquidity discounts are prompting many advisers to counsel their clients to divest themselves of entity control. See, *e.g., Estate of Albert Strangi,* TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (*Strangi II*); *Estate of Wayne C. Bongard* (2005) 124 TC 95. See §1.37. This may alleviate the transfer tax problem, but it will complicate securities law compliance, because divestment is likely to be treated as a disposition under §§13(d) and 16.

The initial contribution to the entity (*i.e.*, in return for 100 percent of the interests) should not trigger short-swing profit issues because it effects only a "change in form" of the transferor's holdings without a change in pecuniary interest. See 17 CFR §240.16a-13. It should not be a §16(b) "matchable" event because there is no opportunity for profit from inside information about the affiliate. See *Kern County Land Co. v Occidental Petroleum Corp.* (1973) 411

US 582, 36 L Ed 2d 503, 93 S Ct 1736.

Subsequent transfers of interests in the entity, however, may trigger short-swing profits issues. Gifts of interests should not cause problems, since bona fide gifts are outside the purview of §16(b). See 17 CFR §240.16b-5(a). In many cases, however, interests are sold (usually for an installment note) in order to avoid gift tax exposure. A sale clearly raises the specter of §16(b) because the sale can generate profits vis-à-vis purchases of the stock within 6 months before and after the sale. However, actual disgorgement will be required (assuming there is a matching event) only if the sale of interests effects a reduction in the seller's pecuniary interest in the entity's stock. If after the sale the seller still controls, or participates in, the entity's voting or investment decisions with respect to the stock (*e.g.*, by remaining the entity's sole general partner), the transfer of interests will not have effected a change in pecuniary interest in the underlying stock. See 17 CFR §240.16a-1(a)(2)(iii); *Widett, Slater & Goldman, P.C.*, SEC No-Action Letter (Mar. 25, 1992), 1992 No-Act Lexis 392.

© The Regents of the University of California

§9.34 4. Invest Part in Exchange Fund

Exchange funds have been a popular way to achieve some measure of diversification since at least the mid-1960s. Investors each contribute stock in a different company to a partnership in return for units in the fund without recognizing gain. Twenty to 25 percent of the value of assets of the fund usually is invested in non-marketable assets, in order to avoid the characterization and related adverse income tax consequences of being an "investment company." See IRC §721(b). The partnership generally distributes enough cash on an annual basis to cover income taxes. After a 7-year lock-up period, the investors may redeem their units in the partnership for a pro rata share of the remaining assets (a diversified portfolio) without recognizing gain. The tax basis in the originally contributed, low-basis securities is carried over to the diversified portfolio. Each investor defers gain recognition until he or she sells the securities received, or the gain may escape income tax altogether if the investor retains the property until death.

Exchange funds usually have significant minimum investment requirements; the stock of only "select" companies may be accepted by the partnership. The manager usually tries to build a portfolio of the stocks of a number of companies from different market sectors, the performance of which will not be highly correlated, in order to reduce risk and increase the expected return. The manager charges a fee. The ownership interests in the exchange fund by any single family group are limited so that the special valuation rules of IRC §2701 will not apply. Most of the income tax rules relating to exchange funds arise under IRC §§351(e), 368(a)(2)(F), and Subchapter K. See generally Jackel & Sowell, *Transfers to Investment Companies: Complexity in a Conundrum*, 94 Tax Notes 1659 (Mar. 25, 2002).

Although no Securities Act Rule 144 filing is required on contribution to an exchange fund (because there is no sale in the public markets), the filing requirements of Exchange Act §§16(a) and 13(d) both apply, and the §16(b) short-swing profit rule potentially applies. Because a contributing insider will not control the fund, the insider's beneficial ownership and pecuniary interest in the contributed shares will necessarily disappear, thus triggering potential reporting requirements under §§13(d) and 16(a). See 17 CFR §§240.13d-1(a), 240.16a-1(a)(2)(iii). Because the stock is exchanged for an interest in the fund, the contribution should be treated as a sale for purposes of §16(b). Consequently, an affiliate should make the investment decision to contribute to the fund when he or she is in an open trading window (and not in possession of material nonpublic information), and should not enter into any purchase or purchase equivalent within 6 months before or after contributing stock to the exchange fund.

Because the objective is to convert a concentrated position into a diversified portfolio without paying income taxes, the fund manager usually retains the contributed stock. Sales do, however, occasionally occur when companies held by the fund become targets of merger and acquisition transactions. Because of the insider's non-controlling position in the fund, it is unlikely that any such sale will subject the contributing insider to reporting or short-swing profit issues under Rule 144 or Exchange Act §13(d), §16(a), or §16(b). See, *e.g.*, 17 CFR §240.16a-1(a)(2)(iii). If the insider and his or her family were to hold at least 10 percent of the interests in the fund, the fund's position could be attributed to the insider, thereby subjecting the fund to the insider's volume limits. See 17 CFR §230.144(a)(2)(iii). As a practical matter, however, Rule 144 is likely to be moot because most merger and acquisition transactions are registered with the SEC, taking them out of Rule 144 purview altogether.

At the end of the 7-year holding period, it is likely that some of the contributed shares will come back to the insider as part of the diversified portfolio. That distribution should not trigger Rule 144 issues, but it may trigger reporting requirements under §§13(d) and 16(a). It may also trigger short-swing profits forfeiture under §16(b) if the insider sells stock within 6 months before or after the distribution. Also, depending on the facts and circumstances, a later sale of the reacquired stock may be subject to Rule 144 and §§13(d) and 16(a) reporting requirements and to §16(b) profit forfeiture.

Some exchange funds offer an estate-freeze feature to combine diversification with transfer tax planning. In return for a contribution of securities, for example, an investor may receive both preferred and common units. Most of the initial value is contained in the preferred units. The common units are good candidates for intrafamily gifts (sometimes to GRATs; see §§9.31-9.31D) or sales (sometimes installment sales to income-tax-defective grantor trusts).

The gift or sale of these common units should not be governed by Rule 144, but they do raise issues under §§13(d),

16(a), and 16(b). However, because the insider will no longer control voting or investment decisions after the stock is contributed to the fund, the insider should no longer have any pecuniary interest in that stock for these purposes. Therefore, the subsequent transfer of the common units will not affect the insider's pecuniary interest in the underlying stock, insulating him or her from reporting or short-swing profits exposure in connection with the gift or sale of the common units. See 17 CFR §§240.13d-3(a), 240.16a-1(a)(2)(iii).

© The Regents of the University of California

§9.35 5. Borrow

An investor holding public company stock may be able to borrow by pledging his or her restricted or control stock for repayment of the debt. The proceeds can be used to finance the exercise of stock options (and pay the resulting tax), to diversify his or her "outside" investment portfolio, for living expenses, or for intrafamily gifts.

NOTE: Relatively low interest rates may make borrowing to finance option exercise particularly attractive. Compared with the cashless exercise of a nonqualified stock option, borrowing to exercise options becomes more attractive as the expected appreciation in the stock to be acquired rises, the spread between market value and strike price rises, the life expectancy of the option holder drops (assuming a basis step-up on securities holdings at death), and interest rates drop.

If an investor's purpose for borrowing is to hold or reinvest in publicly traded, "marginable" securities, then only 50 percent of the purchase price of the stock can be borrowed from a United States bank. See Federal Reserve Board Regulation U (12 CFR pt 221). Somewhat stricter rules apply to United States broker-dealers (see Federal Reserve Board Regulation T (12 CFR pt 220)), and the interest paid likely will be deductible only to the extent of the investor's investment income. See IRC §163(d). Borrowing for other purposes generally is not subject to the margin loan rules, however, but deducting the interest thereon may be more problematic. See IRC §163(h).

Pledging restricted securities for repayment of a loan should not be subject to the constraints of or be reportable under Rule 144, §16, or §13. The Rule 144 prerequisite of a sale in the public markets is missing. Moreover, the lender has acquired no beneficial ownership for purposes of §§13(d) and 16, provided that the pledge does not include power over voting or disposition of the shares (absent a default) and the lender is a regulated financial institution (or one of certain other kinds of lenders). See 17 CFR §§240.13d-3(d)(3), 240.16a-1(a)(1).

In the event of a default, however, a creditor's sale of the underlying securities may be reportable. If the borrower defaults and the lender takes the stock in foreclosure, there should be no Rule 144 consequences because that would be a private transaction. However, the subsequent sale of the stock by the lender to satisfy the debt will have consequences under Rule 144, depending on the holding period. The lender is generally treated as having acquired the stock when the borrower acquired it, at least if the loan is a recourse loan. See 17 CFR §230.144(d)(3)(iv). (Technically, this provision applies to foreclosure only against affiliates, but its application has been extended to non-affiliates as well. See *Morgan Stanley & Co.,* SEC No-Action Letter (Nov. 29, 1984) 1984 SEC No-Act Lexis 2766.) If the borrower has held the stock for at least 6 months before pledging it (and the lender itself is not otherwise treated as an affiliate), the lender will be free to sell the stock after foreclosure. See 17 CFR §230.144(d)(3)(iv). Consequently, a lender may be reluctant to take restricted stock as collateral, unless the borrower can show that he or she has held the stock for at least 6 months before the loan is consummated.

Additional complications arise when the loan is nonrecourse. In that case, the lender's holding period begins on the date of the pledge. 17 CFR §230.144(d)(3)(iv). As a result, if a default occurs within the first 6 months of the loan, the lender will not be able to sell the collateral until the 6-month period expires. Finally, any sales during the 6-month period after the foreclosure can be aggregated with the borrower's sales in computing the volume limits applicable to the borrower's sales if the borrower is an affiliate.

As for reporting under §§13(d) and 16(a), the lender's potential obligation to report (assuming its ownership exceeds the requisite 5-percent or 10-percent threshold) commences no later than the time it declares a default and takes control over the voting or disposition of the stock. See 17 CFR §§240.13d-3(d)(3), 240.16a-1(a)(1). Any subsequent sale of the stock to satisfy the debt is also potentially reportable and subject to short-swing profits exposure. The borrower has to report the disposition of the shares when the lender's beneficial ownership commences and may have short-swing profits exposure if the borrower has purchased or purchases stock within 6 months before or after the default.

An investor may be very risk-averse about obtaining a margin loan because a drop in stock price can result in a margin call. If the investor cannot satisfy the call with other collateral immediately, his or her stock will be sold, potentially depressing the price of the stock and triggering additional margin calls. The market will become aware of this

situation because of the SEC report, and a death spiral may result. The potential for §16(b) matching will preclude the investor from buying back in for at least 6 months if the price continues to drop. To avoid this situation, the investor may enter into a hedge as a way to reduce the likelihood of a stock sale due to a margin call. See §§9.36-9.45. A derivative transaction (see §9.37) may not be feasible for stock during the immediate post-IPO period, however, but a so-called proxy hedge in which securities of other companies in the same industry are hedged may provide an alternative (albeit imperfect) way to hedge against some of the market risk of the concentrated position.

© The Regents of the University of California

§9.36 6. Hedge Risk With Derivative Transaction

Investors may hedge a stock position by purchasing a put option to reduce risk while retaining ownership (and attendant voting rights). See §9.38. Other investors sell call options to enhance yield, or purchase and sell call options with the same expiration date but different strike prices to leverage a limited amount of upside potential. In general, hedging involves many of the financial and non-financial considerations of an outright sale and is not suitable for all investors with restricted or control securities.

NOTE: An affiliate may not sell "short" control stock unless the insider owns at least as many shares as are sold short and those shares are delivered within 20 days of the trade, *i.e.,* a sale "short against the box." 15 USC §78p(c); 17 CFR §240.16c-4. After enactment of IRC §1259, short-against-the-box transactions generally fell out of favor as hedging techniques. Internal Revenue Code §1259 recharacterizes these transactions as constructive sales of the underlying "long" position unless the short sale is closed out no later than shortly after the end of the year and the "long" stock remains unhedged for at least 60 days thereafter. See IRC §1259(c)(1)(A), (c)(3)(A).

Hedging may facilitate borrowing under attractive terms (see §9.46) that permit the investor to convert some portion of the value of the underlying stock position into cash ("monetizing") while deferring gain recognition. Hedging is sometimes accomplished with a 10b5-1 plan. See §9.4.

© The Regents of the University of California

§9.37 a. Derivative Transaction Terminology

Like tax lawyers, people in the derivatives industry employ their own jargon. Derivative transaction terms used in §§9.36-9.45 are defined below.

- "Derivative" or "derivative contract" means a contractual relationship in which the value of each party's position is derived from the value of an underlying security. For example, a call option is an option contract that gives the holder the right to buy a certain quantity of an underlying security from the option writer (seller), at a specified price (the "strike" price) on or before a specified date. The equity value of a call option is derived by comparing the exercise (or strike) price with the prevailing value of the stock itself. However, options also have "time" value, which is attributable to the right to purchase the security at a fixed price over the option term. Therefore, even an "out of the money" option (*i.e.*, a call option whose strike price is above current market price for the stock) has some value because of the control it gives the holder during the option period.
- "Monetize" is often used to mean converting some portion of the value of an underlying security position into cash, usually without triggering taxable gains.
- "Counterparty" means the other party to a derivative contract with the customer, typically a bank, brokerage, or other financial institution.
- "Premium" means the amount paid by one party to a derivative contract at the outset of the contract to acquire his or her position. For example, a person who thinks a stock will appreciate in value pays a premium for a call option to buy the stock at a fixed price until a specified point in time in the future.
- "Cashless" describes a derivative contract in which neither party pays the other at the outset of the contract because each has an obligation to the other of equal value. A "cashless collar," for example, involves one party selling a call option at a price above the prevailing market value while simultaneously buying a put option (see §9.38) at or below the prevailing market value with the same maturity date. The "spread" between the strike prices of the two options is set so that the premium on each option is the same. For example, a call option set at 122 percent of current market value may generate the premium required to pay for a put option at 95 percent of current market value, so that an up-front cash payment is not required by either party. See §9.40.
- "Settlement" means the delivery of stock (physical settlement) or cash (cash settlement) to satisfy an obligation that one party to a derivative contract owes the other party at maturity. If the strike price of a call option is less than the market price of the underlying stock at the expiration of a contract, for example, the person who sold the call option must deliver either the stock in exchange for the strike price or make a cash payment equal to the excess of the market price over the strike price. The income tax consequences triggered by settlement vary depending on the method chosen to settle the contract. Options purchased in the United States (often referred to as "American-style" options) typically allow exercise at any time on or before the expiration date. In contrast, "European-style" options are generally exercisable only at expiration. The more sophisticated hedging strategies discussed in §§9.40-9.47 (*e.g.,* collars and prepaid forward sales) are usually written in the European style, meaning that early termination requires renegotiation of the contract and can result in added costs.

© The Regents of the University of California

§9.38 b. Put Options

Although not particularly common in the authors' experience, the simplest way for an investor to hedge the risk inherent in a concentrated position of restricted or control securities is to buy a put option. The diagram in §9.39 summarizes this kind of derivative transaction.

NOTE: While an insider may acquire puts in order to hedge a stock position, he or she may not acquire them for purposes of speculation. Exchange Act §16(c) prohibits an insider from owning puts when he or she does not own an equivalent amount of the stock. See 15 USC §78p(c); 17 CFR §240.16c-4. In addition, during the term of the put, any dividends paid on the underlying stock will not be qualified dividend income and therefore will be subject to tax at ordinary income tax rates. See IRC §§1(h)(11)(B)(iii), 246(c)(4).

A put option is an option to sell a certain quantity of an underlying security at a specified price (the exercise or strike price) on or before a specified date. In effect, it sets a floor under the value of the stock at the expiration of the option contract. The counterparty (see §9.37) bears all of the risk of the stock dropping below the strike price. This technique can be used to preserve some or all of the upside potential in the stock and enhance the investor's ability to diversify by borrowing against the stock and reinvesting the proceeds (with no margin call risk, but subject to margin lending limits (see §9.35)). The principal disadvantage is that it requires an out-of-pocket payment. In effect, buying a put option is buying a guarantee of a minimum sale price while the contract remains in effect.

An investor's purchase of a put generally is not reportable under Securities Act Rule 144, but is reportable under Exchange Act §16(a) and is a sale equivalent for §16(b) purposes. See 17 CFR §§240.16a-4(a), 240.16a-3(g)(1), 240.16b-6(a). Consequently, an insider must avoid any purchase for 6 months before and after buying the put option. Entry into the put is also reportable by a 5-percent shareholder required to file a SEC Schedule 13D, but not by an SEC Schedule 13G filer until physically settled. If the investor is hedging a substantial portion of his or her holdings, the market may react almost as if there had been a sale. If the insider exercises the put, additional reporting obligations will arise. See 17 CFR §§240.16a-4(c), 240.16a-3(g)(1). However, the exercise of the put is exempt from short-swing profits penalties. See 17 CFR §240.16b-6(b).

An alternative method of hedging a risk is through the use of a "cashless collar." See §§9.40-9.45.

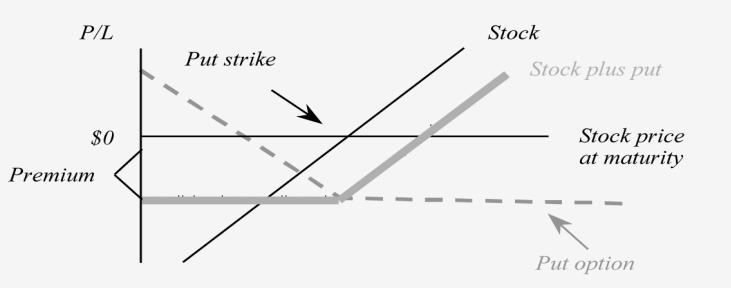
© The Regents of the University of California

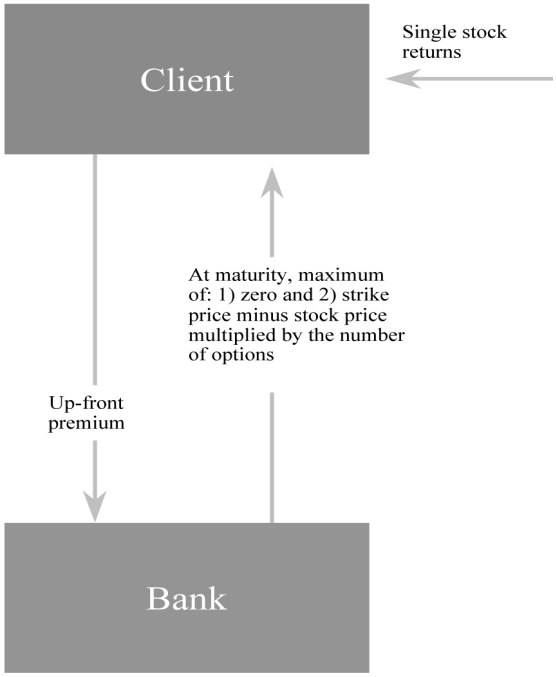
§9.39 c. Diagram: Put Options

Print

Put options provide "insurance" against a decline in the value of a single stock

- Client pays an up front premium
- Bank agrees to pay the difference between the strike price on the put and the market value of the stock at maturity
- Strike price, maturity, and exercise price are flexible
  - –strike prices can be set at-the-money to lock in 100% of stock value today or
  - –can be set out-of-the money (10%–20% below the current price is common)
- Client retains all upside, dividends, and voting rights
- Client can borrow against hedged position at attractive rates





T17972

Comment: This diagram summarizes a technique for hedging a risk by purchasing a put option. See §9.38.

© The Regents of the University of California

§9.40 d. Cashless Collar

Because most investors who hold concentrated stock positions do not want to use other resources to buy the protection of a put contract (see §9.38), so-called cashless collars (see §9.37) have become very popular. See diagram in §9.41.

A "cashless collar" combines the acquisition of a put option with the concurrent sale of a call option with the same maturity date. Using this technique, the shareholder sells off a portion of the upside potential in the stock to finance the cost of the downside protection (instead of paying a put premium out of other assets). If the stock drops below the strike price of the put option (the floor), the shareholder will generally deliver the stock at maturity and collect the protected amount. The transaction is treated as a sale for the strike price, producing long-term capital gain if the stock was held for more than 1 year before the collar was put in place. If the stock appreciates in excess of the strike price of the call option (the ceiling), the shareholder will generally deliver stock in exchange for the ceiling amount, and all appreciation beyond the ceiling will go to the counterparty. Again, the transaction will be treated as a sale of stock for the strike price, and long-term capital gain will result if the stock was held for more than 1 year before entering into the collar. See Rev Rul 78-182, 1978-1 Cum Bull 265 (Rulings B3 and C4); Temp Treas Reg §1.1092(b)-2T(a)(2).

If the stock price stays within the "collar," the shareholder bears all of the potential for gain and loss. No gain or loss is recognized on the expiration of the contract in that situation. When coupled with a loan, a cashless collar or a put can reduce portfolio risk by financing tax-advantaged diversification.

PRACTICE TIP: Collar transactions usually anticipate other forms of settlement. For example, if the stock price is below the floor, the investor may receive a cash payment from the counterparty to settle the contract, thus keeping the stock. Doing so will avoid recognition of gain on the stock, but the cash payment will be taxed as short-term capital gain because of the "straddle" rules. See Temp Treas Reg §1.1092(b)-2T(a)(1). If the stock price exceeds the ceiling, then cash settlement (*i.e.,* payment by the investor to the counterparty of the equity value of the embedded call option) will also produce different results. No gain is recognized on the stock, but the cash payment will be treated as a long-term capital loss if the underlying stock was held for more than 1 year before the collar was initiated. See Temp Treas Reg §1.1092(b)-2T(a)(2). However, the deduction of that loss will be deferred until the stock is sold. See Temp Treas Reg §1.1092(b)-1T(a)(2). In effect, the loss becomes a part of the stock's basis to be recovered only on disposition.

NOTE: A collar or other hedging strategy cannot be used to protect gain that is short term at the time the contract is put into place. The straddle rules restart the stock's holding period at zero when the contract expires unless, when the contract is entered into, the stock had been held for more than 1 year. See Temp Treas Reg §1.1092(b)-2T(a)(2).

Generally, the stock subject to the collar is pledged as collateral to secure the shareholder's obligation to deliver the stock if its price exceeds the ceiling at the expiration of the contract. During the contract term, the shareholder retains voting power and usually collects any dividends.

As long as collars preserve a significant potential for economic gain or loss, they should not constitute a constructive sale for tax purposes. See IRC §1259. See also H Rep No. 148, 105th Cong, 1st Sess (1997), reprinted in 1997 US Code Cong & Admin News 678, 832 (discussing amendments to IRC §1259 contained in Pub L 105-34, §1001(a), 111 Stat 788).

PRACTICE TIP: To date, there are no regulations or rulings that define the minimum participation required to avoid constructive sale treatment. However, for a 3-year or shorter transaction, a collar of 15 percent to 20 percent around the existing stock price is usually considered reasonable within the industry. Moreover, in a ruling dealing with a prepaid, variable forward contract (see §9.46), the IRS implicitly approved an arrangement under which the shareholder kept the first 25 percent of appreciation. See Rev Rul 2003-7, 2003-1 Cum Bull 363.

© The Regents of the University of California

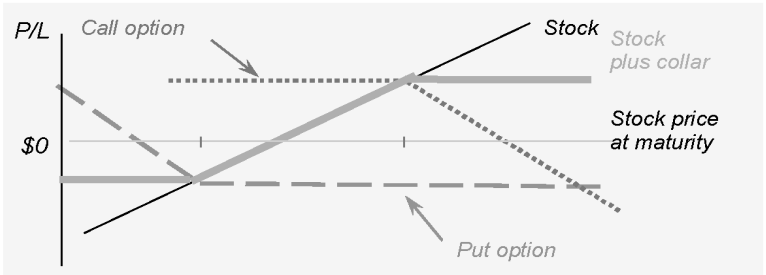
Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.41 (1) Diagram: Cashless Collar

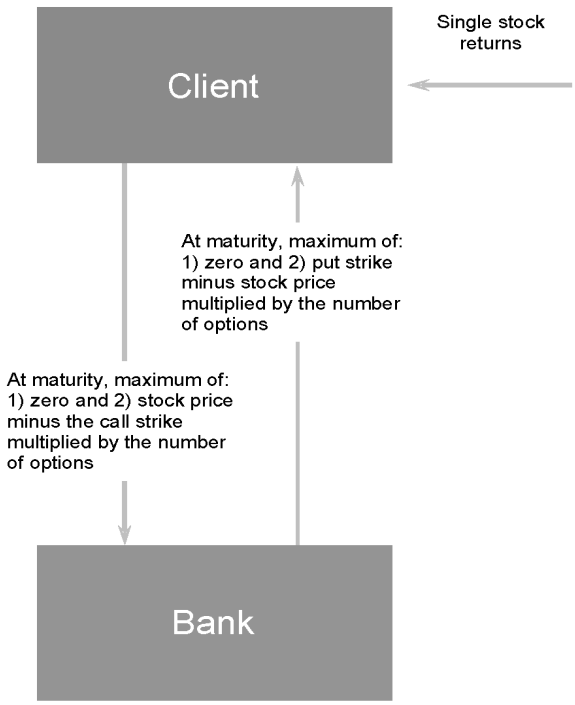
§9.41 (1) Diagram: Cashless Collar

Print

Cashless collars provide same downside protection but eliminate upfront premium by forgoing some upside

- Consists of buying a put and selling a call with same maturity
  - specify level of downside protection needed (e.g., 10%-20% OTM)
  - strike on call set to generate premium to pay for put
- At maturity, payout of the collar depends on market value of stock
  - if share price < put strike, Bank pays difference between put strike and market price
  - if share price > call strike, client pays difference between market price and call strike
- Properly structured collars should not be considered a "constructive sale" for tax purposes
- Client can borrow against hedged position at attractive rates





T17972

20

Comment: This diagram summarizes a cashless collar transaction. See §§9.40-9.43.

© The Regents of the University of California

§9.42 (2) Reporting Requirements; Estate Tax Consequences

An insider's entry into a cashless collar usually is reportable under Exchange Act §16(a) and under Exchange Act §13(d) if the 5-percent ownership requirement is met. See 17 CFR §§240.16a-3(g)(1), 240.16b-6(a). However, it should not be reportable under Securities Act Rule 144. However settled, expiration of the collar must be reported under §16(a). See 17 CFR §§240.16a-4(b)-(c), 240.16a-3(g)(1). It also should be reported on SEC Schedule 13D if the insider is required to file that form, but it need not be reported on an SEC Schedule 13G.

If the insider dies during the term of the collar (or put option), he or she probably will get a basis adjustment in the stock as if the collar were not in place. See IRC §1014; compare Rev Rul 73-524, 1973 Cum Bull 307, with IRS Letter Ruling 9319005. See generally Rev Rul 2003-7, 2003-1 Cum Bull 363.

PRACTICE TIP: The stock should be reported on the estate tax return as an asset (see IRC §2031(a)), and the derivative contract as a separate asset or liability depending on the value of the contract at the date of death (see IRC §§2031(a), 2053(a)). See generally IRS Letter Ruling 8601007, which suggests that any negative value of a collar at the date of death should not merely be used to increase or reduce the value of the underlying stock at the date of death.

No distributable net income should result when the contract is closed or settled. See IRS Letter Rulings 9319005, 9436017, 8601007.

NOTE: During the term of the contract, any dividends paid on the underlying stock will not be qualified dividend income and therefore will be subject to tax at ordinary income tax rates. See IRC §§1(h)(11)(B)(iii), 246(c)(4). Also, Rule 16c-4 (17 CFR §240.16c-4) requires an equity position at least equal to the number of shares hedged for the entire term of the contract.

© The Regents of the University of California

§9.43 (3) Disadvantages for Insiders

A collar can be problematic for an insider. Entry into the collar constitutes a constructive sale for §16(b) purposes. See 17 CFR §240.16b-6(a). Consequently, the insider cannot enter into a collar within 6 months after purchasing stock or within 6 months before he or she intends to purchase stock. If at maturity the stock price is below the put strike, delivery of the stock to settle the contract should be exempt from §16(b) consequences. See 17 CFR §240.16b-6(b). However, physical settlement may not be an option for the insider (see Note below), and cash settlement should be treated as a purchase of the underlying stock under §16(b). See 17 CFR §240.16b-6(a). If the stock price is above the floor price, then settlement should be treated as a purchase of the stock retained by the investor at settlement, whether physically settled or settled in cash. See 17 CFR §240.16b-6(d). In addition, the prospect that some or all of the insider's position will be sold at maturity raises concerns about the market perception of any such sale. Since the sale will occur well into the future, it is impossible to forecast the prevailing mood of the market at that time.

NOTE: In practice, physical delivery of restricted or control stock is an unlikely alternative. The counterparty usually will insist that the collar (or a put) cannot be physically settled if the stock has appreciated enough that the price at expiration is "above" the call strike price, because of the restrictions imposed on the counterparty in hedging or disposing of the stock after physical settlement. As a practical matter, counterparties feel they must refrain from hedging any portion of their own position for at least 30 days after entering into the contract with an affiliate that allows physical settlement, in order to make sure the transaction is exempt from registration as a private sale under §4(1) of the Securities Act (15 USC §77d(1)). In addition, the counterparty would have to comply with Rule 144 restrictions and hold the shares acquired in physical settlement for at least 6 months before it could begin to sell them. 17 CFR §230.144(d)(1). (In practice, counterparties usually hedge much of their own risk at the outset of a contract and adjust their own position periodically during its term.)

Other hedging variations include "knock-in collars," "participating collars," "put spread collars," and "call spread collars." For a discussion of these techniques, see Ellis, *The Basics of Derivatives for Trust and Estate Lawyers: Puts, Call, Collars and Forwards*, 9 Cal Trusts & Estates Q 23 (Summer 2003).

© The Regents of the University of California

§9.44 (4) Put and Call Options Within GRATs

Despite its potential disadvantages for an insider (see §9.43), a cashless collar, otherwise desirable in mitigating the risk of a concentrated position, may lend itself to transfer tax planning for someone who is *not* an officer, director, or 10-percent shareholder. The put and call options that are the components of a collar may be executed through separate GRATs, in order to enhance the hedging strategy with a tax-efficient wealth transfer component.

With this hedging technique, the shareholder creates two "zeroed-out" GRATs, *i.e.,* GRATs whose remainder interests are valued at zero. For discussion of "zeroed-out" GRATs, see Drafting California Irrevocable Trusts §15.5 (3d ed Cal CEB 1997). The grantor funds one GRAT (GRAT A) with the shares to be hedged and the other GRAT (GRAT B) with cash to cover the cost of put options that provide downside protection to the GRAT. If the grantor has other assets outside GRAT A that can be used as collateral, the grantor sells call options and uses the premium received to fund GRAT B. Otherwise, the grantor sells call options using the shares as collateral before the GRATs are established. The shares subject to the call are then transferred to GRAT A and the cash to buy the put is transferred to GRAT B. In either case, the put and call strikes are set so that the call premium is enough to pay for the put. However, as noted below, using the latter method to finance the cost of call options caps the ultimate reward to the remaindermen.

Using this technique, the potential appreciation in the stock and the downside risk protection inure to the benefit of the grantor only to the extent required by the IRC §7520 valuation tables. Any increase in value in either GRAT that exceeds the §7520 rate will inure to the benefit of the remainder beneficiary of one of the GRATs. This is a classic example of a technique in which opportunity is shifted at little or no transfer tax cost. It also enhances the results (beyond that of a single GRAT funded just with shares) by creating an advantageous wealth transfer outcome even if the stock price drops.

The economics of this technique are summarized in the diagram in §9.45.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.45 (5) Diagram: Economics of Option Transactions Within GRATs

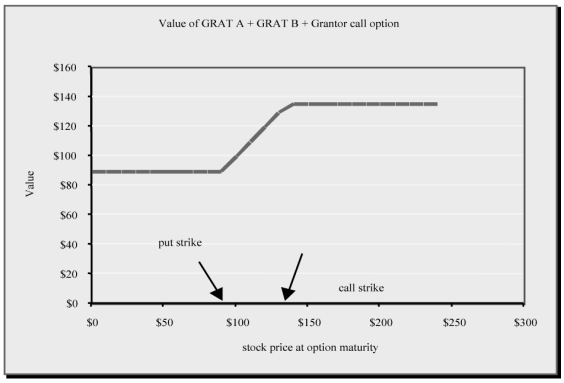
§9.45 (5) Diagram: Economics of Option Transactions Within GRATs

Print

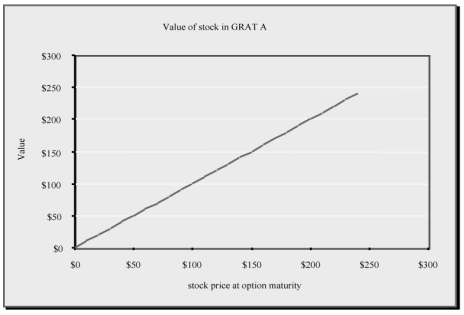
Economics of the option transactions within the GRATs

- If stock price at option maturity is below put strike
  - –Bank pays GRAT B the difference between put strike and stock price
- If stock price at option maturity is between put strike and call strike
  - –both put and call expire
- If stock price at option maturity is above call strike
  - –Grantor pays Bank the difference between stock price and call strike

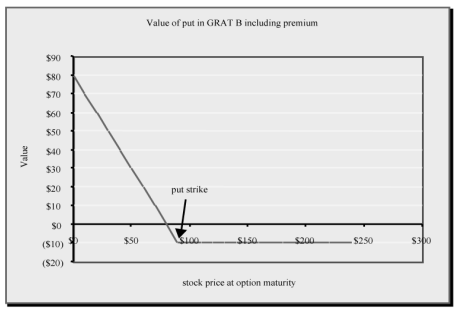
GRAT A + GRAT B + Grantor



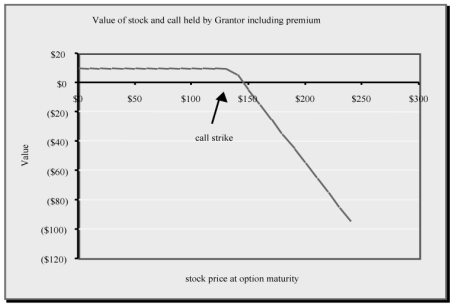
GRAT A



GRAT B



Grantor



In the illustration, it is assumed the call option is held by the Grantor

T17972

Comment: This diagram summarizes the economics of a technique using the components of a cashless collar and two GRATs. As illustrated in the diagram, the grantor, GRAT A, and GRAT B, *as a group,* have the same position that an investor has in any collar transaction, but the components have been divided.

- If the stock price at maturity of the collar transaction is below the put strike price (the bottom of the collar), any appreciation in the value of the put contract in excess of the IRC §7520 rate is transferred to the remainder beneficiaries of GRAT B with the grantor retaining any annuity payments from the two GRATs. This will consist of all of the shares contributed to GRAT A (because the return on GRAT A is negative and, therefore, below the IRC §7520 rate) and a portion of the value of the puts (paid out as annuities from GRAT B).
- If the stock price at expiration of the derivative contract is between the put strike and the call strike (the top and bottom of the collar), the grantor will have received the stock from GRAT A not passing to the remainder beneficiary. All the puts will have expired worthless, and the remaindermen will have received stock from GRAT A to the extent the stock's growth exceeded the IRC §7520 rate during the term of GRAT A (if any).
- If the stock price at expiration exceeds the call strike price (the top of the collar), the remainder beneficiaries of GRAT A will benefit by the portion of the stock's appreciation in excess of the IRC §7520 rate, but all the puts will expire worthless. The amount transferred to the remainder beneficiaries of GRAT A depends on the manner in which the premium on the call option is financed. If the grantor sells calls on the stock before it is contributed to GRAT A, then the remainder beneficiaries' upside is capped at the call strike. However, if the grantor finances the call option premium by pledging other shares (or other assets) outside GRAT A, then the remainder beneficiaries of GRAT A will receive all of the upside beyond the IRC §7520 rate. Clearly, the latter course is potentially much more beneficial to the remainder beneficiaries.

There is no guarantee that any wealth will be transferred, and this kind of transaction comes with transaction costs—but those elements are true with any GRAT. At the expiration of the collar, neither GRAT may be "in the money," and in no event will both be. The novelty of this strategy is that there *will* be a wealth transfer if the stock goes either up or down substantially.

NOTE: Other GRAT strategies using derivatives are discussed in Akers & Parker, *GRAT Strategies—Ringing the Bell at the County Fair*, 29 ACTEC J 92 (2003).

© The Regents of the University of California

7. Combine Borrowing, Hedging, and Tax Deferral With Prepaid, Variable Delivery Forward Sale

§9.46 a. Prepaid, Variable Delivery Forward Contracts

At least for affiliates, prepaid, variable delivery forward contracts are economically similar to, but more attractive than, borrowing against a collared stock position (see §§9.40-9.45). As with a collar, a forward contract typically trades away the stock's potential appreciation above a specified ceiling in order to finance protection from a decrease in stock value below a specified floor. The investor keeps the entire possibility of gain (and, perhaps, loss) between the floor and ceiling. The cash paid to the investor up front is not taxable until the contract matures (usually several years later).

The investor enters into a contract to sell to the counterparty an amount of stock that is determined at the expiration of the contract by reference to the stock price at the time of delivery (up to a specified maximum). The investor receives a payment at the beginning of the transaction for most of the current value of the specified maximum number of shares (usually 80 to 90 percent) and can use these funds for any purposes. The discount compensates the counterparty both for the shifting of downside risk and for what amounts to an embedded interest charge for the use of the sales proceeds until the contract matures. The amount of the discount reflects the term of the contract, the volatility of the stock, the level of the floor and ceiling prices, whether the stock pays a dividend, who is entitled to it, and prevailing interest rates. Typically, the investor pledges the specified maximum number of shares as security for performance of his or her obligations at the expiration of the contract.

The investor usually has the option to settle the contract at maturity by delivering the number of shares specified in the contract or their cash equivalent. These contracts usually run between 1 and 5 years, but sometimes longer. Of course, the longer the contract term the less the proceeds paid up front.

An affiliate must report the entry into the transaction on SEC Form 144 and will be subject to the holding period and volume limits and other constraints of Securities Act Rule 144. See §§9.5-9.10. See also *Goldman, Sachs & Co.,* SEC No-Action Letter (Dec. 20, 1999) 1999 SEC No-Act Lexis 974. Consequently, the number of shares pledged to the forward sale cannot exceed the number of shares that could have been sold by the insider under the applicable volume limits at the time the contract was put in place. Because the prepaid forward contract gives protection against price declines, an insider must report the transaction as a sale equivalent and will be subject to short-swing profits forfeiture if he or she has matching purchases within 6 months before or after the contract is executed. See 17 CFR §§240.16b-6(a), 240.16a-3(g)(1). The insider may also have to report under Exchange Act §13(d) (see §9.13).

If the market value of the stock at the expiration of the contract does not exceed the share price at the outset, the investor delivers the "maximum" number of shares used in determining the payment on account (or the cash equivalent) and the counterparty bears any loss. For example, assume that the shareholder agrees to sell up to 200 shares of stock valued at $100 at the outset for $90 per share, is protected against any decline in price below $100, and trades away all of the upside beyond $120. If the value at the expiration of the contract is $70, the shareholder must deliver the 200 shares maximum (but nothing else), and the counterparty bears the $30 per share loss. The shareholder keeps the proceeds received up front.

PRACTICE TIP: Although the counterparty has the risk of loss if the stock price drops below the floor specified in the contract, as a practical matter counterparties hedge this risk by selling stock short in the market. (The same is true for collars and other hedging devices.) Consequently, there must be sufficient shares available for the counterparty to borrow to effect such short sales and sufficient "float" in the shares to allow the counterparty to move into and out of the short position as the price of the stock changes during the term of the contract. These requirements can sometimes make a particular stock unhedgeable with these techniques. The institution should not borrow the customer's shares for this purpose, because it could trigger a constructive sale for tax purposes. See IRS Letter Ruling 200604033.

If the stock value at the expiration of the contract exceeds the price at the beginning, but not the ceiling price, the

investor delivers less than the maximum number of shares (or settles the contract with cash) and enjoys the benefit of all of the appreciation in value. Continuing the assumptions above, suppose the price at expiration is $110. The shareholder delivers about 182 shares (equivalent to the $20,000 value of his or her stock at the outset) and keeps about 18 shares (reflecting the $10 per share increase in value of the 200 shares).

Finally, if the stock value at maturity exceeds the ceiling price, the investor delivers less than the maximum number of shares (or settles the contract with cash), keeps the appreciation up to the ceiling price, and forgoes the appreciation above that price. Suppose the price at expiration is $130. The shareholder delivers about 169 shares, giving the counterparty the benefit of the original $20,000 value plus $10 per share appreciation (above $120), while retaining 31 shares and capturing the $20 per share appreciation reserved to the investor under the contract (worth about $4000 in the aggregate).

PRACTICE TIP: As a practical matter, the investor should not consider entering into a prepaid variable forward contract unless he or she believes there is significant appreciation potential in the stock over the contract term (but is worried about downside risk). Absent upside potential, it is difficult for the investor to come out ahead when the upfront discount is taken into account, even factoring in the tax deferral. The investor is better off selling the stock outright. And, if the investor is not worried about downside risk (*e.g.,* if the stock is only a minor part of his or her net worth), the investor should simply hold the stock unhedged, reaping all the upside and avoiding the cost of downside protection.

The delivery of the shares triggers a sale for income tax purposes. The taxable gain will be the excess of the proceeds received at the outset (usually 80 to 90 percent of the value of the shares at the outset) over the aggregate basis of the shares actually delivered at maturity. The gain will be long-term capital gain if the investor held the stock for more than 1 year before entering into the contract. See Treas Reg §1.1092(b)-2T(a). The retained shares suffer no tax consequences and retain their original tax bases. During the term of the contract, however, any dividends paid on the underlying stock will not be qualified dividend income and therefore will be subject to tax at ordinary rates. See IRC §§1(h)(11)(B)(iii), 246(c)(4).

During the term of the forward contract, the investor retains the right to vote the stock and usually receives any dividends on the stock. The expiration of the contract generally triggers a reporting obligation for insiders under §16 for affiliates and may trigger one under §13(d) for 5-percent shareholders. See 17 CFR §240.16a-3(g)(1). Short-swing profits exposure under §16(b) will depend on the stock price at maturity and the means used to settle the contract. For example, physical settlement should not constitute a purchase equivalent, if the price at maturity is below the floor. See 17 CFR §240.16b-6(b). However, if the price at maturity is above the floor, then the investor will retain some of the shares pledged to the contract, and those shares should be treated as having been purchased for §16(b) purposes. Cash settlement should be treated as a purchase because this will trigger a return of stock to the insider that was treated as sold at the outset. Dictum in a recent case suggests, however, that the manner of settlement does not convert an exempt transaction into a matchable one. See *Donoghue v Centillium Communications, Inc.* (SD NY, Mar. 28, 2006, 05 Civ 4082) 2006 US Dist Lexis 13221.

NOTE: The treatment of prepaid variable forward contracts under §16(b) is not well settled; indeed, the technical structure of the contractual relationship may affect the treatment.

Economically, a prepaid forward sale limits the investor's potential losses, and, if the stock appreciates, the "first dollars" inure to his or her benefit. Most or all of any appreciation beyond that reserved to the investor inures to the benefit of the counterparty. Economically, this is similar to a cashless collar with a loan equal to the put value of the investor's position less the embedded interest, option, and other transaction costs.

Properly structured, any gain or loss should not be recognized until the investor's obligation to deliver the stock (or cash) under the contract is satisfied. At maturity, the embedded interest charge and payment of the transaction costs reduce gain. Note that although the investor will not be able to deduct the interest element currently (as might be the case with a margin loan), it is implicitly deducted in determining gain or loss because the amount realized has already been reduced by these costs. However, there is no explicit charge for interest (and indeed the transaction is not a loan), so the investor need not worry about the investment interest limits.

PRACTICE TIP: Sometimes a prepaid forward sale is a desirable alternative to a margin loan because the embedded

interest rate often is lower than the rate for margin loans. In addition, less security may be required because this transaction is not subject to the Regulation U (12 CFR pt 221) 50-percent limit for margin loans incurred to acquire publicly traded securities. Then again, in the case of a loan against a collared position, interest expense is available to shelter investment income from other sources taxable at ordinary rates (*e.g.,* taxable interest received from corporate bonds), while the implicit reduction in capital gains at the maturity of a prepaid variable forward contract saves taxes at much lower rates (currently).

NOTE: The IRS has raised questions about the proper treatment of the embedded interest charges in forward contracts. See IRS Notice 2008-2, 2008-2 Int Rev Bull 252. In particular, the Notice questions whether interest should be accrued for tax purposes by the parties during the contract term.

Recent rulings have shed additional light on the parameters that the IRS views as critical to the income tax treatment of prepaid variable forwards. The essential issue is whether the entry into the contract constitutes a constructive sale that triggers immediate recognition of gain. See IRC §1259. If the investor retains sufficient exposure to the benefits and burdens of ownership of the underlying stock, IRC §1259 should not trigger this result. See Rev Rul 2003-7, 2003-1 Cum Bull 363. However, Rev Rul 2003-7 also discusses constructive sale treatment under case law principles that developed before enactment of IRC §1259 (*i.e.,* pre-1997). Specifically, when the taxpayer is considered to be "economically compelled" to deliver the stock pledged under the forward contract at maturity, constructive sale treatment follows. A taxpayer is economically compelled to deliver the stock, for example, when the contract requires physical settlement and the taxpayer has no stock other than that pledged in the forward transaction. In addition, the IRS found constructive sale treatment when the counterparty was allowed by the customer to borrow the stock that the customer pledged to the counterparty under the contract, in order to effect short sales to hedge the counterparty's liability to the customer under the contract. IRS Letter Ruling 200604033. See also Coordinated Issue Paper LMSB-04-1207-077 (Feb. 6, 2008), on the IRS website at http://www.irs.gov/businesses (click on "Coordinated Issue Papers").

PRACTICE TIP: In order to reduce the risks presented by pre-§1259 constructive sale principles, a taxpayer is well-advised to avoid pledging his or her entire stock position under a single forward contract, to require a cash settlement option in the forward contract, and to avoid lending the pledged shares to facilitate the counterparty's short sales.

In the authors' experience, most practitioners believe that if an investor dies during the term of the contract, his or her successors should receive similar tax treatment as if the investor held a collar. See §9.42.

PRACTICE TIP: It is important for the estate to consult with the counterparty about the value of the hedged position and the desirability of closing it out early. Many derivative contracts have provisions that give parties options at the investor's death. Moreover, there may be value in the derivative contract that will dissipate over the remaining term unless the estate captures it early on. For example, it is not unusual for a prepaid forward contract to have positive value to the estate even while the stock price is well below the floor price. This value will be lost if the executor fails to terminate the contract early. This seems counterintuitive. If the price is well below the floor, the estate will receive nothing at maturity unless the stock appreciates significantly before maturity. The obligation to deliver what is expected to be all of the estate's shares pledged to the contract would seem to indicate a zero net value to the estate. However, the mere fact that the contract *may* deliver net positive value (if the stock price rises enough over the remaining term) often gives it a positive value. This is similar to the positive value of an "out of the money" call option, and it can be captured by terminating the contract early. However, this is a wasting asset, and as such should be dealt with as soon as possible after death.

There are a number of variations of forward contracts, including "knock-in forward contracts" (in which obligations are triggered by future changes in the value of the underlying stock), "post-paid forward contracts" (in which the shareholder is paid at the expiration of the forward contract), and "interim-paid forward contracts" (in which the shareholder is paid at some point during the term of the forward contract). The last variation might be of particular interest to an executor or successor trustee who will need cash to pay estate tax, but does not need the cash immediately on entry into the contract.

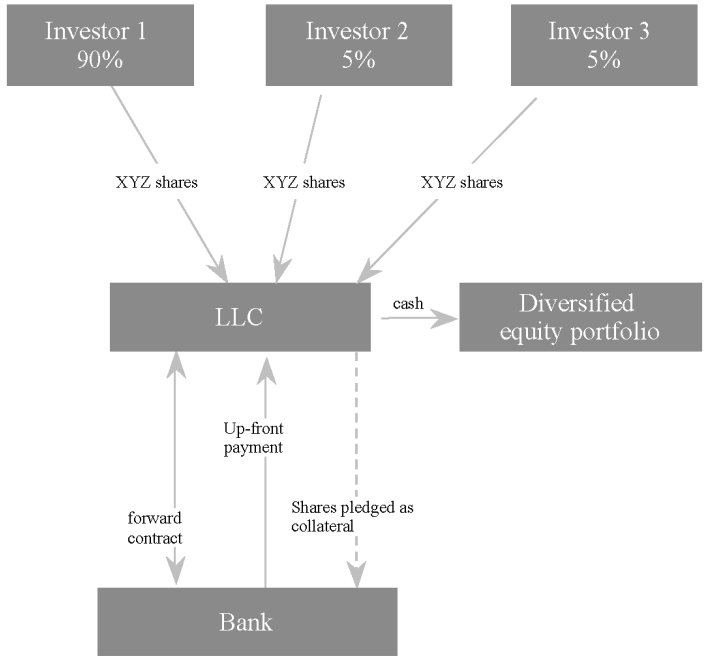
© The Regents of the University of California

§9.47 b. Diagram: Personal Exchange Funds

Print

Personal Exchange Funds (PEFs) provide investors with the benefits of a prepaid, variable, forward contract and the potential for permanent diversification

- Investors contribute same stock to limited liability corporation (LLC)
  - structured properly, contribution of stock should be considered a non-recognition event for tax purposes
  - income, expenses, gains, and losses generated by LLC are allocated to investors in proportion to their ownership interest
- LLC enters into forward transaction
  - upfront proceeds can be actively managed in accordance with investment objectives of LLC
- At or prior to maturity, the LLC may choose to:
  - take no action, allowing the forward to mature within LLC
  - roll the forward within the LLC
  - sell the diversified portfolio and reinvest or distribute proceeds to investors
  - make a liquidating distribution of partnership assets and/or liabilities to one or more investors in accordance with their share of the LLC's net value. For example:
  - distribute single stock subject to forward liability
    - distribute diversified portfolio



% ownership is for illustrative purposes only

TI7972

Comment: This diagram illustrates a variation on forward contracts (see §9.46). A prepaid variable delivery forward sale for a seven-year term can be combined with a "private" exchange fund for a family unit to increase flexibility at the expiration of a forward contract. On exchange funds generally, see §9.34.

As with the GRAT strategy involving derivatives described in §9.44, this plan may achieve nothing but incur transaction costs when compared with each family member entering into a forward contract individually. On the other hand, it provides more flexibility than a "simple" long-term forward contract and presents some interesting planning opportunities as a result of the interaction of the exchange fund, partnership, and hedging rules.

Recent changes in the partnership tax rules may make private exchange funds less desirable than in the past. See, *e.g.,* IRC §743(b). Nevertheless, this mechanism can allow a family to extract cash from a concentrated position without paying tax on the built-in gain in that position and to use the cash to invest in a diversified portfolio specifically tailored to their needs. It is far more flexible than the comparable exchange fund. See §9.34. However, a full explanation of this technique requires a deep discussion of sophisticated partnership tax issues, which is beyond the scope of this chapter.

© The Regents of the University of California

§9.48 8. Increase Insurance Coverage

The volatility of the public equity markets in recent years has led some investors with concentrated positions, particularly in restricted and control securities, to accept the need for disability or life insurance protection to mitigate the potential consequences of either temporary or long-term declines in stock value. Increasing insurance coverage might also help avoid the need to sell a senior executive's stock at a time when the market may be under stress because of concerns about the effect of that executive's incapacity or death on the company's future prospects.

© The Regents of the University of California

§9.49 IV. PLANNING FOR POSTDEATH ADMINISTRATION

Nonvested, restricted, and control securities complicate postdeath administration with remarkable frequency. Sometimes, the problem is as simple as collecting nonvested compensatory stock held in an account with an employer that has vested at death or cleaning up a few shares of restricted stock the decedent obtained in a distribution from a venture capital fund. At other times, the situation is more complicated.

© The Regents of the University of California

§9.50 A. Selection of Fiduciary

The personal representative or successor trustee of a living trust may be an insider subject to the same or more securities law restrictions than the decedent. If an insider acts as a fiduciary, his or her insider status can affect the transferability of the shares held by the estate or trust and its reporting requirements.

Selecting an affiliate as a trustee may require reporting for control stock and perpetuate reporting requirements for restricted stock. It may also require adherence to volume limits for restricted stock (see §§9.5-9.10). The trustee's holdings and the trust holdings may be aggregated for Rule 144 volume limits if they are considered acting in concert. See 17 CFR §230.144(e)(3)(vi). The trust's stock may be aggregated with the trustee's own to determine §§13(d) and 16(a) (15 USC §§78m(d), 78p(a)) reporting requirements (see §§9.12-9.13), depending on the facts and circumstances. For example, if the trustee is an affiliate, the trust will be considered an affiliate as well, regardless of the status of the grantor. See 17 CFR §230.144(a)(2). If the trustee or the trustee's immediate family has a "pecuniary interest," sales of the trust stock or purchases by the trust may give rise to profit forfeiture under Exchange Act §16(b) (15 USC §78p(b)). See §9.12.

PRACTICE TIP: Most of these securities law issues can be avoided by using an independent, nonaffiliated trustee or a special trustee (similarly independent and nonaffiliated) who has exclusive voting and investment control over the affected stock position. Accordingly, before making fiduciary appointments, donors, testators, and advisors should carefully examine the relationships of their intended fiduciaries to public companies in which they hold an interest.

Conflict-of-interest problems are not unusual, either, for an individual who may have been a business partner of the decedent or a corporate fiduciary. Sometimes the problem will arise (or be ameliorated) because the decedent has identified an investment advisor or special trustee to make decisions with respect to a concentrated block of stock. Planning for these difficulties, both in routine, "boilerplate" administrative provisions and in provisions tailored for clients who hold restricted securities, is advisable. See Practice Tip in §9.55, and sample form in Appendix A in §9.59.

© The Regents of the University of California

B. Estate Protection Option

§9.51 1. Hedging Versus Selling

Just as the decedent may have chosen to hedge a concentrated stock position, a personal representative or successor trustee may be even more concerned about doing so. Fiduciaries tend to be more risk-averse than many individual investors—and more concerned with the company-specific risk that comes with a concentrated position. Although fiduciaries in the postdeath period usually want to maximize the value of a holding for beneficiaries, they also want to minimize the risk of loss. Moreover, most trusts and estates lawyers counsel personal representatives to sell concentrated positions quickly to avoid exposure to market volatility—particularly in the face of fixed estate tax obligations. Of course, failure to do so can lead to personal liability for failing to diversify as required under the Uniform Prudent Investor Act. See Prob C §16048.

Hedging concentrated stock risk may be particularly attractive as a means to take potential advantage of the alternate valuation date. Hedging provides protection against potential liability for failure to diversify while the decedent's representative waits for the alternate valuation date to roll around. An estate can take advantage of the downside protection for about two-thirds of the cost to anyone else if the estate is in a 50-percent estate tax bracket and a 25-percent combined federal and state capital gains bracket.

EXAMPLE: Consider an executor's purchase of a put option to protect a concentrated stock position for 6 months after death. If the stock appreciates in value, the executor elects to use the date-of-death value for estate tax purposes and the postdeath gain in the stock is taxed at capital gain rates. The executor has hedged the downside risk at the cost of buying the put and has kept the upside potential in the stock. If, on the other hand, the stock declines in value, the executor makes the alternate valuation date election, pays estate tax on the lower value, exercises the put, and delivers the stock at a gain over the market price. The estate comes out ahead on an after-tax basis, regardless of which way the stock price moves, provided it moves more than a minimal amount up or down. If the stock price on the alternate valuation date varies only minimally from the date-of-death price, the estate will be diminished due to the cost of the put. However, as noted below, it may be possible to treat that cost as an administrative expense on the decedent's estate tax return.

Obviously, this technique lends itself easily to quantitative modeling, and the critical question may be the tradeoff between the amount of downside protection (whether the put is at market value at the date of death or something lower), on the one hand, and the cost of the put, on the other. For an illustration of this technique, see §9.52.

NOTE: Any gain realized on the put will likely be long-term capital gain if the contract is settled by delivery of the stock. Such stock should be treated as an asset held by the estate for more than one year. See IRC §1223(10). Moreover, any gain on settlement of the put contract (*i.e.,* when the stock declines) should be treated as gain from the sale of the stock. See Rev Rul 78-182, 1978-1 Cum Bull 265, 268 (Ruling C4). If the stock value rises and the put expires unexercised, the premium paid by the estate should be a short-term capital loss. See IRC §1234(a)(2). That loss will reduce the tax on any capital gains recognized by the estate, with any excess loss being attributed to the estate's residuary beneficiaries when the estate terminates. See IRC §642(h). An argument can be made, however, that the put premium can be claimed as an administration expense (analogous to the cost of insuring a tangible asset against loss) deductible under IRC §2053(a)(2), but the authors are unaware of any rulings or case law directly supporting such a deduction.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.52 2. Table: Example of Hedging as Estate Protection Option

§9.52 2. Table: Example of Hedging as Estate Protection Option

Assumptions:

- Date of death value = $100
- Marginal tax rates
- Estate tax = 50 percent
- Federal and California long-term capital gains = 25 percent
- Put premium $7 for $100 price guarantee
- Put premium is deductible against or otherwise reduces long-term capital gains
- Ignore dividends and any return from reinvestment of sale proceeds

Alternative 1: Sell at date-of-death value; proceeds = $50 (after estate taxes)
Alternative 2: Use the EPO and sell in 6 months

Stock Price in Six Months	Immediate Sale	Use EPO; Sell in Six Months	Net Benefit (Cost) of EPO vs. Immediate Sale
$50.00	$50.00	$57.25	$7.25
75.00	$50.00	51.00	1.00
79.00	$50.00	50.00	—
93.00	$50.00	46.50	(3.50)
100.00	$50.00	44.75	(5.25)
107.00	$50.00	50.00	—
125.00	$50.00	63.50	13.50
150.00	$50.00	82.25	32.25

PRACTICE TIP: For the sake of simplicity, this example assumes a put for the full value of the estate's stock position. However, protection of the full value is overkill because the estate's real interest is only the excess value over the inherent estate tax liability embedded in the stock. That is, for each dollar the value of the stock declines, the estate loses only 50 cents on a net basis (assuming a 50-percent estate tax rate). On the other hand, the purchased protection is not free of tax. Any gain on the put when the stock price declines will trigger capital gains taxes. To compute the proper amount to hedge, these tax savings and costs must be taken into account. In actuality, the perfect hedge will equal that portion of the decedent's stock position that is equal to the ratio of 1 minus the estate tax rate (or 50 percent in this case) divided by 1 minus the capital gains rate (or 75 percent in this case). Hence, in this example, a put for two-thirds of the value of the stock is all that is necessary to fully protect the estate.

© The Regents of the University of California

C. Drafting Considerations

§9.53 1. Retention of Securities

The estate planner should consider authorizing the personal representative or the trustee (or an investment advisor or special trustee) to retain nonvested, restricted, or control securities for some period of time, particularly if a significant holding is involved. If retention is authorized, the planner probably should have the testator or grantor waive, or at least modify, the duty to diversify. Alternatively, the planner may want to direct relatively early disposition or hedging of the holding. In either event, the planner will want to consider the constraints of the securities laws, the potential availability of the blockage discount, and the effect on corporate control.

NOTE: Proxy fights occasionally have erupted after the death of a holder of a significant block of securities because of the potential for controversy about an "interested" personal representative's exercise of discretion in voting the stock.

© The Regents of the University of California

§9.54 2. Discretion to Sell

The estate planner probably will want to give the personal representative or trustee broad discretion in selecting among ways to sell restricted or control securities. This may include the power to:

- Modify the normal conflict of interest rules to permit a person who is an employee, officer, director, or shareholder to act without undue personal risk;
- Facilitate a repurchase by the company or a purchase by the company's employee stock ownership plan;
- Make a nonpublic sale of a substantial block; or
- For either an individual engaged in the securities business or a corporate fiduciary that has an affiliate engaged in the securities business, execute a sale through a business enterprise in which the fiduciary is somehow "interested."

© The Regents of the University of California

§9.55 3. Borrowing and Investing

The estate planner should consider authorizing the fiduciary to pledge restricted or control securities even if the securities do not constitute a significant, concentrated position. If the fiduciary needs to borrow, the power to pledge restricted or control securities will allow the fiduciary to use a broadly diversified portfolio of publicly traded securities to support a margin loan. The client also may want to authorize some kinds of self-dealing transactions.

In addition, the planner should authorize the fiduciary to acquire derivative instruments as a way to hedge risk (whether as a part of the estate protection option discussed in §9.51 or otherwise). Particularly if the client has entered into similar contracts with affiliates of a corporate fiduciary, the client may want the fiduciary to enter into the contract with an entity in which the fiduciary has an interest.

PRACTICE TIP: It is the authors' view that the emergence of institutions that can provide a wide array of financial services, including fiduciary services, compels a relaxation of the traditionally strict duties of loyalty and avoidance of conflicts of interest. The problem is that many of these firms' "best ideas" relating to investing are proprietary. When they also act as trustee, investing in these strategies can be problematic under such duties. However, appropriate modification of the duties in the instrument can go a long way toward alleviating the problem. See Appendix A in §9.59 for suggested language to be added to the will or trust to address conflicts that arise when an institutional fiduciary (or its affiliate) intends to perform services in relation to the estate or trust that are beyond the scope of pure fiduciary services.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.56 4. Exculpatory Language

§9.56 4. Exculpatory Language

If nonvested, restricted, or control securities represent a substantial holding, the estate planner may wish to include exculpatory language tailored to insulate the personal representative or trustee from liability for decisions regarding the holding. Including such language may encourage the fiduciary to make decisions in the fashion contemplated by the client.

© The Regents of the University of California

§9.57 5. Valuation and Distribution Problems

The planner may want to include special provisions to deal with the complications that can arise on the distribution of restricted and control securities—the constraints on sale and potential "taint" that may arise from distributions in kind. For example, the securities law restrictions can raise valuation questions for funding marital gifts, charitable gifts (including split-interest trusts), and pecuniary gifts. See, *e.g., Ahmanson Found. v U.S.* (9th Cir 1981) 674 F2d 761; IRS Letter Ruling 9403005. The securities law restrictions can also raise particular problems for administration of trusts that require distributions at specified times because restricted stock may not be as easily distributed in kind as other assets.

In addition, the planner may want to include specific authority permitting the personal representative or trustee to engage experts to support a blockage discount argument for estate tax purposes. See §9.18.

PRACTICE TIP: Compensatory stock may be a good candidate for marital deduction gifts because the built-in income tax liability is ignored in valuing assets for estate tax purposes, income tax on the IRD assets may deplete the surviving spouse's estate, and other, non-IRD assets will be more valuable to "taxable" beneficiaries. See IRS Letter Ruling 200247001.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.58 6. Consider Charitable Gifts

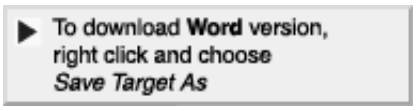
§9.58 6. Consider Charitable Gifts

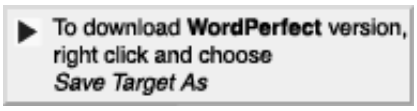
As with other assets that give rise to income in respect of a decedent under IRC §691, nonvested, compensatory stock may be a particularly good candidate for charitable gifts because a charity will not have to pay tax on the income. See IRS Letter Ruling 200012076.

© The Regents of the University of California

V. APPENDIXES

§9.59 A. Form: Resolving Conflicts for Corporate Trustees in Relation to Investments





9.59-1 Conflicts of interest; introductory clause

Conflicts of Interest

a. I _ _[*name of settlor*]_ _ recognize that a trustee generally has duties to administer a trust solely in the interests of the beneficiaries, not to use or deal with trust property for the trustee's own profit or for any purpose unconnected with the trust, and not to undertake a trust relationship in which the interests of the beneficiaries of that new relationship are adverse to the interests of the beneficiaries of the existing trust. I intend to limit those duties with respect to this trust relationship.

9.59-2 Reason for selecting corporate trustee

b. *Reason for Selecting Corporate Trustee.* I have selected _ _[*name of corporate trustee*]_ _ to act as a trustee of this trust in part because of the breadth of the services and products that it and its parents/affiliates and subsidiaries of each offer in the ordinary course of business, including, but not limited to, investment management services; custody services; real estate management services; brokerage services; the management of common trust funds and mutual funds; "sponsoring" private investments in private equity, hedge, venture capital, and other funds; acting as a principal in derivative transactions, including hedging transactions and structured investments derived therefrom; art advisory services; philanthropic services; valuation services; and lending services. I do not wish to disqualify _ _[*name of corporate trustee*]_ _ from providing, and being compensated for providing, these other services just because it is acting as a trustee.

9.59-3 Waiver of duty of undivided loyalty and duty to avoid conflict of interest

c. *Waiver of Duty of Undivided Loyalty and Duty to Avoid Conflict of Interest*. I recognize that _ _[*name of corporate trustee*]_ _ acts (and in the future may act) as trustee of trusts for the benefit of people who may have interests that conflict with the beneficiaries of this trust. I also understand that any individual acting as a co-trustee of this trust may have similar kinds of conflicting interests arising out of investment matters, business enterprises, the provision of services or products, and other trust relationships. _ _[*Name of corporate trustee*]_ _ and each individual who may act as a co-trustee from time to time shall not be disqualified or constrained in any respect by reason of the rules of undivided loyalty, the duty to avoid conflicts of interest, and the duty not to undertake an adverse trust from participating in any action, inaction, or transaction with respect to and on behalf of this trust, as trustee of any other trust or personally. It is my intention to waive any and all such rules with respect to each trustee named in this instrument or selected in accordance with the provisions of this document.

9.59-4 Examples of authorized transactions

d. *Examples of Authorized Transactions.* By way of example, the Trustee is authorized, in the exercise of sole and absolute discretion, to enter into transactions with, and/or retain the services of, any trustee (including _ _[*name of corporate trustee*]_ _) or any affiliate of any trustee (including _ _[*name of corporate trustee*]_ _) on such terms and conditions as the Trustee deems advisable, including, but not limited to, transactions or services in which the Trustee (including _ _[*name of corporate trustee*]_ _) or any affiliate (i) acts as a broker or dealer to execute security, insurance, real estate, and any other transaction on behalf of this trust estate or any trust; (ii) purchases assets from or sells assets to this trust estate or any trust (including, but not limited to, contracts of insurance, short sales of securities, puts and calls, options and futures contracts offered by any exchange trading in options and futures or otherwise, hedging transactions utilizing spreads and straddles, financial instruments commonly known as "derivatives," and structured investments);

(iii) lends money to the trust estate or any trust; (iv) acts as the manager and/or has an interest, including investments by the trust in any partnership, limited liability company, fund, or other entity that is managed by the Trustee (including _ _[*name of corporate trustee*]_ _) or any affiliate; or (v) engages in any other transaction (whether as an agent, as a principal, as a counterparty, or in any other capacity) with, or renders any other services to, the trust estate or any trust. The Trustee also is authorized, in the exercise of sole and absolute discretion, to invest in any money market deposit or similar account or securities of the Trustee (including _ _[*name of corporate trustee*]_ _) or any affiliate, or in one or more mutual funds, common trust funds, hedge funds, private equity funds, exchange funds, or any other investment funds, whether or not the Trustee (including _ _[*name of corporate trustee*]_ _), or any affiliate, renders services to such fund and receives compensation from such fund.

9.59-5 Right to trustee compensation

e. *Right to Trustee Compensation.* Both _ _[*name of corporate trustee*]_ _ (acting in more than one capacity or providing more than one kind of service) and any affiliate shall be entitled to compensation from the trust estate both for any "other" service(s) provided and for serving as Trustee as if all services were provided by unrelated entities and without any reduction of the compensation because _ _[*name of corporate trustee*]_ _ (or an affiliate) is acting both as trustee and in another role.

9.59-6 Trustee actions to be judged by unrelated third person standard

f. *Trustee Actions to be Judged by Unrelated Third Person Standard.* Any action, inaction, or transaction involving any trustee to whom the general duties of loyalty to avoid conflicts of interest and not to undertake an adverse trust otherwise might apply, including (without limitation) those described in paragraph d: (i) shall not be void, voidable, or otherwise subject to attack solely for the violation of any such rule; (ii) may be taken, refrained from, or entered into without giving any notice to a beneficiary and without resulting in any liability or reduction in compensation solely for the violation of any such rule; (iii) shall be judged by the same standards and rules of law that would apply if the same were taken, refrained from, or entered into by, between, or among strangers free of any element of divided loyalty or conflicting interest; and (iv) may be engaged in without approval or authorization from any court or any beneficiary under this clause.

9.59-7 Optional approval by trust protector

g. *Optional Approval by Trust Protector*. Although I do not intend to limit the breadth of the foregoing provisions, I want to reduce the potential for controversy by establishing a mechanism to approve specific transactions whenever more than one trustee is acting. I specifically authorize _ _[*the trust protector/any disinterested trustee or trustees*]_ _ to waive any duty of undivided loyalty to avoid conflicts of interests or not to undertake an adverse trust with respect to a trustee otherwise affected. I intend that the _ _[*trust protector/disinterested trustee or trustees*]_ _ have the sole and absolute discretion to determine when it is advisable to make such a specific waiver. Any such waiver must be in writing, must describe the action, inaction, or transaction, and must describe the duty being waived. Although the _ _[*trust protector/any disinterested trustee or trustees*]_ _ is authorized to waive any such duty, a waiver shall not be required to engage in any transaction and the failure to obtain a waiver shall not prevent the Trustee from engaging in any transaction nor affect my waiver of the general duties of loyalty to avoid conflicts of interest and not to undertake an adverse trust. I also authorize the Trustee acting from time to time to waive any similar duties with respect to any agent of a Trustee. Again, I intend that the Trustee have the authority to grant this waiver in the exercise of the Trustee's sole and absolute discretion.

9.59-8 Liability for willful neglect and misconduct, bad faith; burden of proof

h. *Liability for Willful Neglect and Misconduct, Bad Faith; Burden of Proof.* This limitation on the duties of loyalty to avoid conflicts of interest and not to undertake an adverse trust relationship shall not apply in the event of willful neglect, willful misconduct, or bad faith. Any beneficiary who questions any action, inaction, or transaction based on the duties of loyalty to avoid conflicts of interest and not to undertake adverse trust relationships shall have the burden to prove that one of these conditions exists by affirmative evidence (and not by inference).

Comment: This form contains suggested language to be added to a trust to deal with the conflicts that arise when an institutional fiduciary (or its affiliate) intends to perform services in relation to the trust that are beyond the scope of pure fiduciary services. The form language can be modified to be used in a will as well.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/9 Estate Planning for Restricted Securities/§9.60 B. Matrix of Securities Law Considerations Related to Restricted or Control Stock

§9.60 B. Matrix of Securities Law Considerations Related to Restricted or Control Stock

Securities Law Considerations Related to Restricted or Control Stock				
Type of Sale Strategy	**Rule 144**	**§13(d)**	**§16(a)**	**§16(b)**
Outright Sale	Shares must be held for a minimum of 6 months and, thereafter, during any 3-month period, sales (by affiliates only) cannot exceed greater of 1% of the outstanding shares, or average of prior 4 weeks' trading volume. In certain cases, multiple sellers are subject to single volume limit. In certain cases, holding periods include period shares were held by preceding owner. Shares bought before IPO are privately placed and therefore restricted. Shares owned by affiliates (senior officers, and certain large shareholders) are "control" shares under Rule 144. No sales or hedges of affiliate shares may be made until company has been filing required SEC reports for 90 days (*i.e.,* post-IPO).	Applies to beneficial owners of greater than 5% of class of publicly traded voting stock. If owner participates in control of company, generally files Schedule 13D; if "passive," files Schedule 13G. Changes in ownership equal to 1% of outstanding deemed "material." If sale is "material," must be reported on Schedule 13D or G; Schedule 13D must be amended promptly (rule of thumb is within 48 hours).	Sale must be reported on Form 4 within 2 business days following transfer.	Sale is matchable against nonexempt purchase(s) made 6 months before or after sale.
Charitable Remainder Trust (CRT)	Transferor to CRT need not comply with Rule 144. In general, CRT can "tack" donor's holding period for Rule 144 purposes. If securities donated by affiliate, and only asset of CRT, and income interest held by affiliate or family member who shares affiliate's residence, then CRT will be deemed same "person" as affiliate and will itself be affiliate (sales by CRT	If donor retains right to vote or dispose of shares after transfer, probably no need to amend Schedule 13G, but probably should amend Schedule 13D in any event. If over 5% of outstanding voting class of publicly traded securities were beneficially owned by CRT, CRT would become subject to reporting requirements of	If donor has or shares control over stock in CRT, donor will be subject to reporting requirements of §16(a) with respect to transactions in equity securities of issuer.	Gift not matchable, but sales by CRT will be considered sales by donor for §16(b) purposes if donor has to report under CRT transactions under §16(a).

	are deemed to be sales by affiliate and vice versa). If securities donated by affiliate, but conditions above do not apply, CRT will follow Rule 144 until holding period (including tacking) equals 6 months.	Section 13(d).		
Outright Gift to Family Member	Donor need not comply with Rule 144. If donee is member of affiliate's household or is a trust having such person as beneficiary, donee will be deemed same person as affiliate and will itself be an affiliate as to future sales by donee. Same if trustee of donee trust is affiliate.	Donor who reports on 13D should amend promptly.	Donor must report gift.	Gift not matchable.
Exchange Fund	Rule 144 need not be complied with on transfer but may need to be followed when fund sells.	Applies (*see* Outright Sale).	Applies to transfer—reported on Form 4	Applies to transfer. Should not apply to later sales by fund
Sell under 10b5-1 Plan	Rule 144 must be complied with for sales by affiliates, and until the 6-month holding period has been satisfied for sales by other holders of restricted stock.	Applies (*see* Outright Sale).	Sales must be reported. Form 4 due within 2 business days after notification by broker, as long as within 3 business days of actual execution when affiliate does not select date of execution.	Applies (*see* Outright Sale).
Type of Hedging Strategy	**Rule 144**	**§13(d)**	**§16(a)**	**§16(b)**
Put Option	Not reportable under Rule 144.	Holder of long put who reports on 13D should amend promptly.	Reportable under §16(a).	Put option is deemed sale for purpose of §16(b). Note: Rule 16c-4 requires person entering into hedge that is treated as sale to be long as many shares as notional amount throughout entire hedge.
Collar + Loan	Not reportable under Rule 144, but lender may be subject to Rule 144 restrictions on sale after foreclosure on stock.	Holder of long put who reports on 13D should amend promptly.	Reportable under §16(a).	Deemed sale for §16(b) purposes. At settlement, investor's receipt of shares could be considered a

				purchase. Similar treatment for cash settlement. Note: Rule 16c-4 requires person entering into hedge that is treated as sale to be long as many shares as notional amount throughout entire hedge.
Prepaid Variable Forward (PVF)	Reportable under Rule 144. Some believe prepaid forwards for affiliates cannot be entered into for 6 months after private placement unless prospectus is available. Form 144 must be mailed to SEC no later than trade date. Form 144 becomes public record when received by SEC. Manner of sale restriction prohibits solicitation of buyers other than brokers who expressed interest in last 60 days, customers who expressed unsolicited interest within last 10 days. Nonrestricted control or 145 stock can be hedged immediately. Volume limits apply (*see* Outright Sale).	Because of inherent downside protection, which resembles a long put, holder of long put who reports on 13D should amend promptly.	Reportable under §16(a).	Deemed sale for purpose of §16(b) filings. At settlement, investor's receipt of shares could be considered a purchase. Similarly, for cash settlement. Note: Rule 16c-4 requires person entering into hedge that is treated as sale to be long as many shares as notional amount throughout entire hedge.
Type of Transfer Strategy	**Rule 144**	**§13(d)**	**§16(a)**	**§16(b)**
Sale to IDGT	Seller need not comply with Rule 144 on sale to IDGT. However, subsequent sales by trustee may be aggregated with sales by grantor.	Applies (*see* Outright Sale).	Reportable under §16(a). Subsequent sale by IDGT reportable if (1) trust is affiliate, (2) trustee is affiliate or immediate family member has 10% beneficial interest, or (3) beneficiary is affiliate and has voting or investment control.	Applies (see Outright Sale).
GRAT	Transfer to GRAT need not comply with Rule 144. However, if grantor acts as trustee (often the case) then GRAT will be affiliate and subject to Rule	If GRAT funded by 13D filer, initial contribution and payment in-kind of annuity obligation may require amendment to	Funding of GRAT is probably not reportable under §16(a). If grantor is trustee, trades by GRAT would be reportable as trades	If grantor is trustee, payment of annuity payment should not be subject to profit disgorgement under §16(b), but other transfers pursuant

	144 volume limitations and holding periods. Payment-in-kind of annuity obligation should not start new holding period for 144 purposes.	Schedule 13D. Transfer to GRAT remainder beneficiaries at termination likely requires amendment to Schedule 13D.	by Grantor.	to voluntary act of grantor probably will be if there is any kind of control, including control exercised by grantor over number of shares used to make annuity payment. *Morales v Quintiles Transnational Corp.* (SD NY 1998) 25 F Supp 2d 369; *Peter J. Kight,* SEC No-Action Letter (Oct. 16, 1997) 1997 SEC No-Act Lexis 946; *Dreiling v Jain* (WD Wash 2003) 281 F Supp 2d 1234.

© The Regents of the University of California

10

Estate Planning With Compensatory Stock Options

Patrick McCabe
Thomas Scholz

I. INTRODUCTION §10.1

II. STOCK OPTION BASICS
- A. What Is a Stock Option? §10.2
- B. Types of Stock Options §10.3
  - 1. Incentive Stock Options (ISOs)
    - a. How Option Qualifies as ISO §10.4
    - b. Income Tax §10.5
    - c. Alternative Minimum Tax (AMT) §10.6
    - d. Withholding §10.7
  - 2. Nonqualified Stock Options (NQSOs) §10.8

III. GIFTING OF NQSOS: TAX AND SECURITIES LAW CONSIDERATIONS §10.9
- A. Gift Tax in General §10.10
- B. Table: Gift Tax Exemptions and Rates §10.11
- C. Gift Tax on Transfer of NQSOs
  - 1. Determination of Gift Tax §10.12
  - 2. Example: Gift of NQSOs to Family Member
    - a. Hypothetical Assumptions §10.13
    - b. Gift of Vested NQSOs §10.14
    - c. Gift of Unvested NQSOs §10.15
- D. Estate Tax in General §10.16
- E. Table: Estate Tax Exemption Amounts and Rates §10.17
- F. Federal Income Tax on Transfer of NQSOs §10.18
- G. Securities Law Considerations §10.19

IV. VALUATION OF NQSOS §10.20
- A. Valuation Under Revenue Procedure 98-34 §10.21
- B. Factors in Option Pricing Model §10.22
  - 1. Expected Life of Option §10.23
    - a. Maximum Remaining Term §10.24
    - b. Computed Expected Life §10.25
  - 2. Volatility of Underlying Stock §10.26
  - 3. Expected Dividends §10.27
  - 4. Risk-Free Interest Rate §10.28

V. TRANSFER OF NQSOS TO CHARITABLE ORGANIZATION
- A. Charitable Deduction §10.29
- B. Illustration: Transfer of NQSOs to Charity §10.30
- C. Securities Law Considerations §10.31

VI. TRANSFER OF NQSOS TO FAMILY LIMITED PARTNERSHIP §10.32

VII. TRANSFER OF NQSOS PURSUANT TO DISSOLUTION
- A. Income Tax §10.33
- B. FICA and FUTA §10.34
- C. Reporting Obligations §10.35
- D. Other Issues
  - 1. ISOs Transferred to Former Spouse §10.36
  - 2. Optionee Exercise of Option on Behalf of Nonemployee Spouse §10.37
- E. Checklist: Company's Responsibilities Regarding Transfer of Options to Nonemployee Spouse §10.38

F. Form: Option Transfer, Consent, and Indemnity Agreement §10.39

VIII. DISPOSITION OF STOCK OPTIONS ON DEATH OF OPTIONEE
A. Exercise of Stock Options by Estate or Heir
1. ISOs §10.40
2. NQSOs §10.41
B. Beneficiary Designation §10.42
C. Form: Stock Option Beneficiary Designation §10.43

IX. APPENDIX: EXAMPLE OF TAX CALCULATIONS FOR SINGLE TAXPAYER ON EXERCISE AND SALE OF ISO §10.44

© The Regents of the University of California

§10.1 I. INTRODUCTION

This chapter covers estate planning considerations for compensatory stock options granted to employees by their employers. Stock options dramatically increased in popularity in the late 1990s and are expected to continue as a significant component of many executives' overall compensation package. As a result, estate planners should have a basic understanding of stock options as well as the fundamental estate planning opportunities involving them.

The chapter defines incentive and nonqualified stock options (NQSOs) (see §§10.2-10.8). It then discusses considerations in making gifts of NQSOs (see §§10.9-10.19), valuation of NQSOs (see §§10.20-10.28), and certain planning opportunities for them, including transfers to family members or charities (see §§10.29-10.32). The chapter also addresses the treatment of NQSOs under a marital dissolution or separation (see §§10.33-10.38). Finally, it discusses the disposition of stock options on the death of the optionee (see §§10.40-10.42).

© The Regents of the University of California

II. STOCK OPTION BASICS

§10.2 A. What Is a Stock Option?

A stock option gives the holder of the option (the optionee) the right to purchase a specific number of shares of a company's stock at an exercise price based on the market value of the stock on the day the option is granted. Typically, only the vested portion of an option may be exercised by the optionee. Options generally vest over a period of three to five years. Most options expire ten years after the date of grant, or sooner in the event of the optionee's death, disability, or termination of service.

© The Regents of the University of California

§10.3 B. Types of Stock Options

From a federal tax perspective, there are two distinct types of compensatory stock options-incentive stock options (ISOs) and nonqualified stock options (NQSOs). This chapter does not address noncompensatory options traded on an established market.

An ISO is an option granted to an individual for any reason connected with his or her employment, if granted by the employer corporation (or its parent or subsidiary), to purchase stock of the corporation. IRC §422(b). It is a form of compensation benefit.

An NQSO (also called a "nonstatutory" stock option) is an option granted in connection with the performances of services that does not qualify as an incentive stock option. See IRC §83(a).

Unlike NQSO gains, ISO gains receive preferential tax treatment. See §10.5. In exchange for this benefit, the Internal Revenue Code places restrictions on ISOs regarding their term, exercise flexibility, and the subsequent sale or other disposition of the shares acquired through exercise of the option. See §10.4. In contrast, the provisions of NQSOs are not as restricted by federal tax law and thus allow for greater design flexibility. See §10.8.

The typical stock option plan may provide for the grant of both ISOs and NQSOs, and the ISO requirements (see §10.4) need not apply to NQSOs granted under the stock option plan.

© The Regents of the University of California

1. Incentive Stock Options (ISOs)

§10.4 a. How Option Qualifies as ISO

An option must satisfy the following criteria to qualify as an ISO (IRC §422):

- It may be granted only to employees of the company and its wholly owned subsidiaries; consultants and nonemployee directors are not eligible to receive ISOs (IRC §422(a)(2));
- It must be granted under a written plan that (IRC §422(b)(1))
- Is approved by the company's shareholders within 12 months before or after its adoption by the board of directors of the company;
- Specifies the total number of shares of stock available for issuance (which must be a fixed limit, not a percentage of the company's outstanding shares);
- Specifies the employees or classes of employees eligible to participate (a designation such as "key employees of the company and its subsidiaries" or "all employees of the company and its subsidiaries" will meet this requirement);
- It may not be granted with an exercise price less than the fair market value of the company's stock on the date of the grant (IRC §422(b)(4));
- It may only be exercised by the optionee (or, if the optionee is incapacitated, by his or her legal representative) and cannot be transferable, other than at death by will, by the laws of descent and distribution, or through a beneficiary designation (see form beneficiary designation in §10.43) (IRC §422(b)(5));
- It may not have an exercise period in excess of 10 years (IRC §422(b)(3));
- It must be granted within 10 years from the earlier of (1) the date of adoption of the stock option plan by the company's Board of Directors, or (2) its approval by the company's shareholders (IRC §422(b)(2));
- Option grants made to employees owning more than 10 percent of the outstanding shares of the company, or any parent or subsidiary, must have a minimum exercise price of 110 percent of fair market value of the company's stock on the grant date, and a maximum exercise period of five years (IRC §422(c)(5));
- The grant value (number of shares multiplied by the fair market value of the company's stock on the grant date) must be capped indirectly through vesting restrictions; specifically, the value of all ISOs granted to an employee that vest in a given calendar year may not exceed $100,000 (IRC §422(d));
- Stock received on exercise of an ISO must be held for the longer of one year following exercise or two years following the grant date of the ISO (IRC §422(a)(1)); and
- Following the employee's termination of employment for any reason, other than death or disability, vested options must be exercised within three months. In the event of disability, this period may be as long as 12 months. IRC §422(a)(2), (c)(6). There is no limit on the period of exercise following death, but most companies allow 12 months.

NOTE: For these purposes, a leave of absence of more than three months is treated as a termination of employment unless reemployment is guaranteed by law (as with certain United States military reservist laws and certain state family leave laws) or by contract. Reg §1.421-1(h)(2).

© The Regents of the University of California

§10.5 b. Income Tax

There are generally no ordinary income tax consequences to the recipient of an ISO or to the company by reason of either the grant or exercise of an ISO. IRC §421(a). If a recipient holds stock for more than two years from the date the ISO is granted and more than one year from exercise of the ISO, any gain or loss on a disposition of the stock will be long-term capital gain or loss. IRC §422(a)(1). Thus, the advantage of ISOs lies in the current difference between the tax rates applied to capital gains and ordinary income (subject to other taxes that reduce or eliminate this advantage). One negative consequence, however, is that the company will not receive a federal tax deduction equal to the recipient's gain because the recipient is not taxed at the time of exercise. In addition, the exercise of an ISO may result in alternative minimum tax (AMT) liability for the employee. For discussion of the AMT, see §10.6.

If the two-year and one-year holding periods are not satisfied, the recipient recognizes ordinary income in the year of the sale or other disposition. This is referred to as a "disqualifying disposition." The amount of ordinary income is generally the lesser of (see IRC §421(b)):

- The difference between the amount realized on the disposition and the exercise price; or
- The difference between the fair market value of the stock on the date the ISO is exercised and the exercise price.

Any gain in excess of the amount taxed as ordinary income will be treated as a long- or short-term capital gain depending on whether the stock was held for more than 12 months. To the extent the recipient recognizes ordinary income because of a disqualifying disposition, the company will be entitled to a corresponding business expense deduction in the tax year in which the disposition occurs (subject to the requirement of reasonableness). IRC §421(b).

NOTE: It is important to note that the tax treatment of an ISO on a disqualifying disposition cannot be avoided.

For examples of the tax calculations related to the exercise and sale of shares acquired under an ISO, see §10.44.

© The Regents of the University of California

§10.6 c. Alternative Minimum Tax (AMT)

The exercise of an ISO may increase an optionee's AMT liability. This is because the difference between the exercise price of an ISO and the fair market value of the shares on the date of exercise (the "spread") must be claimed as an adjustment item for AMT purposes. IRC §56(b)(3). If an optionee's AMT liability exceeds his or her regular income tax liability, the optionee will owe the greater amount of taxes. To avoid the application of AMT, the optionee must sell the shares *within the same calendar year* in which the ISOs were exercised. A sale within the same year of exercise, however, will constitute a disqualifying disposition. See §10.5.

© The Regents of the University of California

§10.7 d. Withholding

Gains recognized by an optionee upon the exercise of an ISO and subsequent distribution of shares acquired pursuant to the exercise of an ISO are not subject to income or employment tax withholding. IRC §421(b).

© The Regents of the University of California

§10.8 2. Nonqualified Stock Options (NQSOs)

Unlike ISOs, nonqualified stock options (NQSOs) are not strictly regulated and allow for more planning opportunities. Their flexibility extends to the exercise price as well as the option term, vesting restrictions, and post-termination exercise rights. In relation to ISOs, special advantages of NQSOs include the following:

- The recipient's gain at time of exercise is deductible by the company as a compensation expense (IRC §83(h));
- There is no limit to the number of options that can be granted or vested in a given year;
- There are no time restrictions on the disposition of the acquired stock; and
- There is freedom to tailor key plan design features, such as the exercise price and the option term.

WARNING: Under IRC §409A, discount options (*i.e.,* options with an exercise price less than the fair market value of the stock on the date of grant) are treated as a form of deferred compensation. Treas Reg §1.409A-1(b)(5)(i)(A). The holder of a discount option may be subject to accelerated income taxation and an additional 20-percent federal penalty tax and 20-percent California penalty tax, plus penalties and interest. IRC §409A(a)(1)(B)(i)(II).

Relative to ISOs, the price for these advantages is that gains from NQSOs are taxed at ordinary income rates and subject to employment tax withholding (including income, Social Security, and Medicare taxes) instead of capital gains rates. Moreover, the tax is due when the option is exercised instead of when the acquired stock is eventually sold. The amount subject to tax is measured by the difference between the fair market value of the stock at the time of exercise and the exercise price. Reg §1.83-7(a).

© The Regents of the University of California

§10.9 III. GIFTING OF NQSOS: TAX AND SECURITIES LAW CONSIDERATIONS

Sections 10.10-10.18 address the income and gift tax consequences to the optionee of transferring NQSOs and to the donee on receiving and exercising the gifted NQSOs. Section 10.19 discusses securities law considerations in transferring NQSOs. By contrast, as noted in §10.4, ISOs may only be exercised by the optionee and cannot be transferred, other than at death.

© The Regents of the University of California

§10.10 A. Gift Tax in General

To prevent tax-free shifting of assets to individuals in lower income tax brackets, the federal government imposes a gift tax on gratuitous transfers of property by an individual during his or her lifetime. See IRC §§2501(a), 2512(b). The gift tax and the estate tax regimes are unified, so that a single graduated rate schedule applies to cumulative taxable transfers made by an individual during his or her lifetime and at death. See IRC §§2001, 2502. Although a marital deduction is available for gifts to a spouse (see IRC §2056), in general, gifts to someone other than the donor's spouse or charitable organizations are taxable regardless of the number of donees or their relationship to the donor (see IRC §2503).

NOTE: There are special limitations with respect to the gift tax marital deduction when the donor's spouse is not a United States citizen. See California Estate Planning, chap 16 (Cal CEB 2002).

A donor generally is entitled to a gift tax exclusion for the first $13,000 (adjusted annually for inflation) worth of property given to each donee during a calendar year. IRC §2503(b); Rev Proc 2009-50, 2009-45 Int Rev Bull 652; Rev Proc 2008-66, 2008-45 Int Rev Bull 1107. A donor may make gifts to an unlimited number of donees each year within the annual exclusion. For the donor to qualify for the annual exclusion, the donee must receive a present interest in the property transferred (IRC §2503(b)(1)), which generally means outright ownership of the property. See Reg §25.2503-3(b) (defining "present interest" as unrestricted right to "immediate use, possession, or enjoyment of property or the income from property").

Gifts of community property are treated as being made one half by each spouse, and both spouses generally must join in the gift. IRC §2513. Spouses also may elect to treat all gifts of separate or quasi-community property by either spouse to a third party during a particular calendar year as though one half of the gifts were made by each spouse. IRC §2513(a). This "split gift" enables spouses to use both of their annual exclusions, applicable credit amounts, and lower tax rates, regardless of whose property is being given away. The election is made on the federal gift tax return for the year in which the gifts are made. Thus, spouses may give $26,000 annually to a donee free of gift tax even if the gift is made from the assets of only one spouse.

Taxable gifts (*i.e.,* those in excess of the gift tax annual exclusion per donee and not qualifying as educational or medical expenses or certain loans of artwork (see IRC §2503(b), (e), (g); Reg §25.2503-1)) are aggregated over the donor's lifetime and subject to gift tax to the extent they exceed the donor's remaining gift tax exemption amount. See IRC §§2010, 2505. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), the lifetime gift tax exemption amount is capped at $1 million. IRC §2505. The gift tax exemption amount therefore completely offsets the tax on cumulative gifts valued at or below $1 million.

The gift tax exemption is tied to the estate tax exemption, so that if an individual uses his or her $1 million exemption amount during lifetime, he or she will have $1 million less of his or her estate tax exemption remaining at death. Lifetime taxable gifts aggregating more than $1 million in value incur tax at rates set forth in the table in §10.11. The tax is computed by applying the unified estate and gift tax rate schedule (see schedule in IRC §2001) to the taxable gifts made by the donor during the year and subtracting the portion of the gift tax exemption amount not previously used to offset gift taxes during previous years. The federal gift tax return (IRS Form 709) must be filed, and any tax due is payable on or before April 15 of the year after the year when the taxable gifts were made. IRC §§6019, 6075(b)(1).

© The Regents of the University of California

§10.11 B. Table: Gift Tax Exemptions and Rates

Year of Gift	Gift Tax Exemption Amount	Gift Tax Rate(s) on Excess
2004	$1,000,000	41-48%
2005	$1,000,000	41-47%
2006	$1,000,000	41-46%
2007	$1,000,000	41-45%
2008	$1,000,000	41-45%
2009	$1,000,000	41-45%
2010	$1,000,000	35%
2011 and after	$1,000,000	41-55%

Comment: Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the top gift tax rates gradually decline, tracking the top estate tax rates through 2009. See IRC §2001(c)(1), (c)(2)(B). When estate taxes are repealed in 2010, the top gift tax rate will equal the top individual income tax rate, scheduled to be 35 percent, but the gift tax rules under prior law will reappear in 2011 unless Congress acts before then to eliminate the sunset provision. See IRC §2210(a).

© The Regents of the University of California

C. Gift Tax on Transfer of NQSOs

§10.12 1. Determination of Gift Tax

If an optionee transfers NQSOs to a family member for no consideration, federal gift taxes are imposed on the fair market value of the NQSOs at the time of the completed gift to the extent that the value of the NQSOs exceeds the gift tax annual exclusion and the amount of the donor's available gift tax exemption. See IRC §§2501(a), 2511, 2512(b). On determining the fair market value of the NQSO, see §§10.21-10.28.

Transfer of an NQSO to a family member is a completed gift under IRC §2511 on the later of (a) the transfer, or (b) the time when the donee's right to exercise the option is no longer conditioned on the performance of services by the donor. Rev Rul 98-21, 1998-1 Cum Bull 975.

© The Regents of the University of California

2. Example: Gift of NQSOs to Family Member

§10.13 a. Hypothetical Assumptions

Assume that on June 1, 2009, an employee of Company A was granted an option to acquire 4000 shares of Company A common stock. The option has a four-year vesting schedule with 1000 shares vesting on each yearly anniversary of the date of grant of the option provided the optionee continues to be an employee of Company A during the vesting schedule of the option. If the optionee terminates employment for any reason, vesting of the option will cease. The following is the vesting schedule:

Vesting Date	Total Number of Shares Vested
June 1, 2010	1000
June 1, 2011	2000
June 1, 2012	3000
June 1, 2013	4000

The option can only be exercised with respect to vested shares. Therefore, the ability to exercise the option is conditioned on the employee's performance of additional services for Company A. If the employee fails to continue performing services, vesting will cease and the unvested portion of the option will be forfeited. The option expires 10 years after the date of grant.

If the optionee's employment terminates for any reason other than death or disability, the vested portion of the option may be exercised no later than 3 months after the termination date. If the optionee's employment terminates because of death or disability, the vested portion of the option may be exercised no later than 12 months after the termination date. Company A's stock option plan permits the transfer of NQSOs to members of an optionee's immediate family.

© The Regents of the University of California

§10.14 b. Gift of Vested NQSOs

Assume the same facts as in §10.13 and that the employee transfers the entire option to one of his children (for no consideration) on January 1, 2014. As of January 1, 2014, all 4000 of the shares subject to the option have vested and are exercisable by the employee. Because the employee has performed the services necessary to exercise all of the shares subject to the option, his right to exercise the option has become binding and enforceable. Because the employee's right to exercise the option is no longer conditioned on the performance of additional services by the employee, the transfer of the option to his child is considered a completed gift *at the time of transfer*. Rev Rul 98-21, 1998-1 Cum Bull 975.

The effect of such a transfer is that the employee's child may now determine whether and when to exercise the stock option and will also be obligated to pay the exercise price. The option will continue to be subject to its original terms and conditions. Accordingly, the child must exercise the option before the expiration date of the option. Further, if the optionee's employment terminates for any reason other than death or disability, the child may exercise the option no later than 3 months after the termination date. If the optionee's employment terminates as the result of death or disability, the child may exercise the option no later than 12 months after the termination date.

If the value of the gifted option exceeds the gift tax annual exclusion, gift taxes will be imposed on the fair market value of the option at the time of the completed gift—in this example, the date of transfer. Rev Rul 98-21, 1998-1 Cum Bull 975. The optionee will be required to pay gift tax on the amount that (1) the fair market value of the gifted option at the time of the completed gift exceeds (2) the gift tax annual exclusion and the amount of the donor's available gift tax exemption. On determining the value of the option for gift tax purposes, see Rev Proc 98-34, 1998-1 Cum Bull 983, discussed in §§10.21-10.28.

© The Regents of the University of California

§10.15 c. Gift of Unvested NQSOs

Assume the same facts as in §10.13 and that the employee transfers the entire option to one of his children (for no consideration) on January 1, 2012. As of January 1, 2012, only 2000 of the 4000 shares subject to the option have vested. Because the employee has performed all of the services necessary to exercise 2000 of the shares subject to the option, the transfer of the 2000 shares to his child is considered a completed gift at the time of transfer. Rev Rul 98-21, 1998-1 Cum Bull 975.

Before the employee performs the necessary services, the rights that the employee possesses in the stock option have not acquired the character of enforceable property rights that may be transferred for federal gift tax purposes. Because the employee's stock option becomes exercisable in stages, each portion of the option that becomes exercisable at a different time is treated as a separate option for purposes of determining whether the right to exercise that portion of the option has become a transferable property right. Rev Rul 98-21, 1998-1 Cum Bull 975.

The employee's right to exercise 2000 shares is still conditioned on his performance of future services. Because he does not have a binding and enforceable right to exercise the 2000 unvested shares, the transfer of the 2000 unvested shares will not be considered a completed gift at the time of transfer. Once the employee performs the services necessary to exercise the 2000 unvested shares subject to the option, however, the transfer of the 2000 shares to his child will be considered a completed gift. If the employee continues to provide services to Company A, 1000 shares will be considered a completed gift on June 1, 2012 (the date when 1000 shares vest), and an additional 1000 shares will be considered a completed gift on June 1, 2013 (the date when an additional 1000 shares vest).

The following table shows when the transfer of the option became a completed gift:

Number of Shares Treated as Completed Gift	Date of Completed Gift	Completed Gift on Transfer or Vesting
2000	January 1, 2012	On Transfer
1000	June 1, 2012	On Vesting
1000	June 1, 2013	On Vesting

If the value of the gifted options exceeds the annual gift tax exclusion and the donor's gift tax exemption, federal gift taxes would be imposed on the fair market value of the options at the time of the completed gift. See §10.14. The 2000 vested shares subject to the option transferred on January 1, 2012, will be valued as of the date of transfer because a completed gift occurred at the time of transfer. The 1000 shares subject to the option that vested on June 1, 2012, will be valued as of that date because the transfer was considered a completed gift when the employee's right to exercise the option was no longer conditioned on his performance of services. Similarly, the 1000 shares subject to the option that vested on June 1, 2013, will be valued as of that date because the transfer was considered a completed gift at the time the employee's right to exercise the option was no longer conditioned on his performance of services.

The option will continue to be subject to its original terms and conditions as described in §10.13.

© The Regents of the University of California

§10.16 D. Estate Tax in General

For federal estate tax purposes, the taxable estate consists of the decedent's gross estate less deductions for (see IRC §§2051, 2053-2058):

- Funeral and administration expenses;
- Debts of the decedent and other valid claims against his or her estate;
- Losses incurred during the administration of the estate; and
- Qualifying devises to charitable organizations and to the decedent's surviving spouse, if any.

To be deductible for estate tax purposes, a devise to a surviving spouse generally must be outright, free of trust, or to a special kind of trust that is exclusively for the benefit of the spouse during his or her remaining lifetime and will be included in his or her gross estate at death. See IRC §2056. See also California Estate Planning, chaps 10, 17 (Cal CEB 2002).

Under the Economic Growth and Tax Relief Reconciliation Act of 2001, net federal estate taxes will be steadily reduced and then repealed in 2010. IRC §2210(a). In the interim, the estate tax exemption amount has been substantially increased. As of 2009, it is $3.5 million. IRC §2010(c). Correspondingly, the estate tax has become a flat tax of 45 percent on the portion of the taxable estate over $3.5 million. IRC §2001(c)(2)(B). The estate tax will disappear in 2010 but reappear in 2011 unless Congress acts before then to eliminate the sunset provision. The changes leading up to the 2010 repeal were phased in according to the table set forth in §10.17.

© The Regents of the University of California

§10.17 E. Table: Estate Tax Exemption Amounts and Rates

Year of Death	Estate Tax Exemption Amount	Estate Tax Rate(s) on Excess
2004	$1,500,000	45-48%
2005	$1,500,000	45-47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	N/A—tax repealed	N/A—tax repealed
2011 and after	$1,000,000	41-55%

© The Regents of the University of California

§10.18 F. Federal Income Tax on Transfer of NQSOs

On transfer. There are usually no federal income tax consequences to the donor or the donee on the transfer of an NQSO, unless it has "readily ascertainable fair market value" at the time it is granted. Reg §1.83-3(a)(2). If it does, the grant itself is a transfer of property and is a taxable event. See Reg §1.83-7(a). An NQSO has a readily ascertainable fair market value at the grant date, and is taxable at the time, if it is actively traded on an established securities market, or, if it is not traded, if it passes the four tests set forth in Reg §1.83-7(b)(1)-(2). See California Estate Planning, chap 22 (Cal CEB 2002).

On exercise. The donor will recognize ordinary income when the donee exercises the NQSO, in an amount equal to the excess of (1) the fair market value of the option shares on the exercise of the NQSO over (2) the exercise price (the "spread"). IRC §83(a). If the donor is an employee or former employee of the company that issued the option, the spread will be subject to withholding for income taxes and FICA (Social Security and Medicare taxes). See Reg §1.83-1(b)(1).

On disposition of shares. The gain, if any, realized on the donee's subsequent sale or disposition of the option shares will constitute short-term or long-term capital gain to the donee, depending on the donee's holding period. The donee's basis in the stock will be the fair market value of the stock at the time of exercise of the NQSO. Reg §1.83-7(a).

© The Regents of the University of California

§10.19 G. Securities Law Considerations

When considering a gift of a NQSO, the donor must take into account applicable securities laws. Publicly traded companies generally register shares subject to stock options under the Securities Act of 1933 (Securities Act) (15 USC §§77a-77aa) on SEC Form S-8. The form is also available for the registration of shares acquired by an optionee's family member who acquired the options from the optionee by gift.

For these purposes "family member" is defined as (Securities Act Rule 701(c)(3) (17 CFR §230.701(c)(3))):

- Any child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships;
- Any person sharing the optionee's household (other than a tenant or employee);
- A trust in which these persons (or the optionee) have more than 50 percent of the beneficial interest;
- A foundation in which these persons (or the optionee) control the management of assets; and
- Any other entity in which these persons (or the optionee) own more than 50 percent of the voting interests.

PRACTICE TIP: Because securities law applicable to the transfer of options is complex, securities counsel should be consulted in connection with any gift of stock options.

© The Regents of the University of California

§10.20 IV. VALUATION OF NQSOS

A taxpayer may determine the fair market value of NQSOs for estate and gift tax purposes using any one of a number of standard valuation methods, such as the Black-Scholes or binomial models. Rev Proc 98-34, 1998-1 Cum Bull 983.

NOTE: The Black-Scholes and the binomial models are two commonly accepted methods of valuing stock options. The Black-Scholes model, developed in 1973 by Fisher Black and Myron Scholes, uses the stock price, strike price, expiration date, risk-free return, and the volatility of the stock's return to calculate the value of a stock option. The binomial model, developed by John Cox, Stephen Ross, and Mark Rubinstein in 1979, takes a risk-neutral approach, in which the possibilities of price changes are reduced, the possibility for arbitrage is removed, a perfectly efficient market is assumed, and the duration of the option is shortened. For a discussion of these models and others, see http://www.riskglossary.com/articles/option_pricing_theory.htm.

Valuation models should consider, among other things, factors such as strike price, the current value and volatility of the underlying stock, the expected dividends on the underlying stock, the risk-free rate of return over the option term, and the option's remaining life. The Internal Revenue Service provides a method of valuation using these factors in Rev Proc 98-34. See §10.21.

© The Regents of the University of California

§10.21 A. Valuation Under Revenue Procedure 98-34

Revenue Procedure 98-34, 1998-1 Cum Bull 983, sets forth a "safe harbor" method for valuing options for estate and gift tax purposes. If the requirements of Rev Proc 98-34 are followed, the IRS will accept the value as properly determined for transfer tax purposes. The IRS method is relevant, however, only when the underlying stock is publicly traded. Rev Proc 98-34, §3, 1998-1 Cum Bull 983, 984.

The option pricing methods permitted under Rev Proc 98-34 take into account factors similar to those established by the Financial Accounting Standards Board in Statement of Financial Accounting Standards No. 123 (Accounting for Stock-Based Compensation) (revised 2004)) (FAS 123(R)). See §10.22. It imposes other restrictions, however, such as the disallowance of market discounts permitted by other valuation models. Rev Proc 98-34, §4.02, 1998-1 Cum Bull 983, 984. Further, the model applies only to the valuation for estate and gift tax purposes of non-publicly-traded compensatory stock options (*i.e.,* stock options granted in connection with the performance of services). Rev Proc 98-34, §3, 1998-1 Cum Bull 983, 984.

If a taxpayer uses Rev Proc 98-34 to value a compensatory stock option for transfer tax purposes, the applicable gift or estate tax return should clearly indicate that the return was "FILED PURSUANT TO REV PROC 98-34."

© The Regents of the University of California

§10.22 B. Factors in Option Pricing Model

The FAS 123(R) valuation methodology (see §10.21) establishes financial accounting and reporting standards for stock-based employee compensation plans. Under FAS 123(R), the fair value of a stock option granted by a public company is estimated using an option pricing model (such as the Black-Scholes model) that takes into account the following factors as of the grant of the option:

- The exercise price of the option;
- The expected life (or term) of the option (see §§10.23-10.25);
- The current price (or fair market value) of the underlying stock;
- The expected volatility of the underlying stock (see §10.26);
- The expected dividends on the underlying stock (see §10.27); and
- The risk-free interest rate for the expected term of the option (see §10.28).

Revenue Procedure 98-34 sets forth guidelines for taxpayers based on FAS 123(R). To take advantage of the valuation "safe harbor" provided by the revenue procedure, the taxpayer must use the factors listed above and explained more fully in §§10.23-10.28. In addition, Rev Proc 98-34 requires that:

- The company that granted the option be subject to FAS 123(R) in preparing its financial statements for the company's fiscal year that includes the valuation date;
- The underlying stock must be common stock and must be the same stock for which the expected volatility and expected dividends were estimated by the company for purposes of FAS 123(R); and
- No discount can be applied to the valuation produced by the option pricing model. For example, no discount can be taken due to lack of transferability or due to the termination of the option within a specified number of days following termination of employment.

© The Regents of the University of California

§10.23 1. Expected Life of Option

In determining the factor for the expected life of the option under Rev Proc 98-34, taxpayers must use either:

- The maximum remaining term of the option on the valuation date (maximum remaining term; see §10.24); or
- The expected life of the option on the valuation date computed in accordance with rules described in §10.25 (computed expected life).

© The Regents of the University of California

§10.24 a. Maximum Remaining Term

To calculate the expected life of the option (see §10.23), the maximum remaining term is the number of years rounded down to the nearest 1/10th of a year from the valuation date until the option's expiration date (assuming no condition or event occurs that would shorten the life of the option). Rev Proc 98-34, §4.03, 1998-1 Cum Bull 983, 984.

Taxpayers must use the maximum remaining term (and may not use the computed expected life) as the expected life of the option on the valuation date if one or more of the following conditions is present (Rev Proc 98-34, §4.04, 1998-1 Cum Bull 983, 984):

- The transferor of the option (or the decedent, for a transfer at death) is not the original person to whom the option being valued was granted by the company;
- Except for a transfer at death, the transferor is not an employee or director of the company on the valuation date;
- Except for the death or disability (within the meaning IRC §22(e)(3)) of the transferor, the option being valued does not terminate within six months of the transferor's termination of employment (or service as a director) of the transferor with the company;
- The terms of the option being valued permit the option to be transferred to, or for the benefit of, one or more persons other than persons who are the natural objects of the transferor's bounty or a charitable organization;
- Except for the death of the transferor, the option being valued has an exercise price that is not fixed on the valuation date; the option does not have a fixed exercise price if, for example, the exercise price is determined by a formula the results of which might change after the valuation date; in addition, an option will be deemed not to have a fixed exercise price if the issuing company has repriced options (*i.e.,* directly or indirectly lowered the exercise price of outstanding compensatory stock options) within the 3-year period ending on the valuation date;
- Except for the death of the transferor, the option being valued has terms and conditions such that if all the options granted in the fiscal year of the company that includes the valuation date had the same terms and conditions, the weighted-average expected life for the year would have been more than 120 percent of the weighted-average expected life actually reported for the year; or
- The company is not required by FAS 123(R) to disclose an expected life of the options granted in the fiscal year of the company that includes the valuation date.

© The Regents of the University of California

§10.25 b. Computed Expected Life

In calculating the expected life of the option (see §10.23), the computed expected life is determined as follows (Rev Proc 98-34, §4.03, 1998-1 Cum Bull 983, 984):

Step one: Obtain the weighted-average expected life of options granted by the publicly traded company that, for purposes of complying with FAS 123(R), is disclosed in its financial statements for the fiscal year that includes the valuation date. (If, instead of disclosing a weighted-average expected life for options granted during the fiscal year, the company disclosed a method for computing the expected life of the options granted during the fiscal year, the taxpayer must compute the weighted-average expected life for the taxpayer's option using the method disclosed by the company.)

Step two: Divide the weighted-average expected life determined in step one by the number of years, rounded up to the nearest 1/10th of a year, from the date the option was granted until the option's expiration date (assuming no condition or event occurs that would shorten the life of the option). For these purposes, the date the option was granted should be determined without regard to the application of IRC §424(h)(1), which provides that, if the term of an option is extended, the extension must be considered the granting of a new option.

Step three: Multiply the quotient obtained in step two by the maximum remaining term. The resulting number rounded down to the nearest 1/10th is the computed expected life expressed in years.

EXAMPLE: On January 1, 2004, an employee is granted a stock option from Company A that will terminate 10 years from the date of the grant or 3 months after termination of the employee's service, whichever is earlier. The option becomes fully exercisable 3 years from the date of grant. For the fiscal year that includes January 1, 2007, Company A discloses in a footnote to its financial statements, in accordance with FAS 123, that the weighted-average expected life of stock options granted by the Company during the fiscal year is 6 years. On January 1, 2007, when the employee's option becomes fully exercisable, the employee makes a gift of the entire option. For purposes of step one, the weighted-average expected life is 6 years. For purposes of step two, the weighted-average expected life of 6 years is divided by 10 years, the maximum term of the employees' option on the date the option was granted by Company A. The resulting quotient is 0.6 (6 years divided by 10 years). For purposes of step three, the quotient determined in step two is multiplied by the maximum remaining term (10 years − 3 years = 7 years remaining) to determine the computed expected life. The result is 4.2 years (0.6 × 7 years). See Rev Proc 98-34, §4.03, 1998-1 Cum Bull 983, 984.

© The Regents of the University of California

§10.26 2. Volatility of Underlying Stock

In determining the factor for the expected volatility of the underlying stock in the option pricing model under Rev Proc 98-34 (see §10.22), taxpayers must use the expected volatility of the underlying stock that, for purposes of complying with FAS 123(R), is disclosed in the financial statements of the publicly traded company for the fiscal year of the company that includes the valuation date. Rev Proc 98-34, §4.05, 1998-1 Cum Bull 983, 985.

© The Regents of the University of California

§10.27 3. Expected Dividends

In determining the factor for the expected dividends on the underlying stock, taxpayers must use the expected dividends on the underlying stock that, for purposes of complying with FAS 123(R), is disclosed in the financial statements of the publicly traded company for the fiscal year of the company that includes the valuation date. Rev Proc 98-34, §4.06, 1998-1 Cum Bull 983, 985. See §10.22.

© The Regents of the University of California

§10.28 4. Risk-Free Interest Rate

In determining the factor for the risk-free interest rate in the option pricing model under Rev Proc 98-34 (see §10.22), taxpayers must use the yield to maturity on the valuation date of zero-coupon United States Treasury Bonds with a remaining term (as of the valuation date) nearest to the expected life of the option on the valuation date. On the expected life of the option, see §§10.23-10.25.

© The Regents of the University of California

V. TRANSFER OF NQSOS TO CHARITABLE ORGANIZATION

§10.29 A. Charitable Deduction

For either philanthropic or tax reasons, an optionee may wish to transfer an NQSO to a charitable organization as a gift. (In contrast to NQSOs, ISOs may only be exercised by the optionee and cannot be transferred, other than at death. See §10.4.) A contribution to a qualified charity is deductible for income tax purposes, subject to certain conditions and limitations. See IRC §170(a)(1), (c), (e)(1)(A). The amount of the deduction generally is equal to the amount of money or the fair market value of any other property contributed. With respect to the transfer of a vested NQSO to a qualified charity, the amount of the charitable deduction would be equal to the value of the option on the date of transfer. "Qualified" charities are defined in IRC §170(c). Presumably, the donor can rely on Rev Proc 98-34, 1998-1 Cum Bull 983, for a "safe harbor" method of determining the fair market value of the transferred option. See §10.21. Although Rev Proc 98-34 provides that its valuation method applies for transfer tax purposes, it seems reasonable to rely on the valuation method of Rev Proc 98-34 for income tax purposes, given that the methodology of Rev Proc 98-34 is not uniquely suited for transfer tax purposes, but should be generally applicable for determining the value of options, regardless of the type of tax at issue. It would be very odd for the IRS to assert that Black-Scholes (which forms the basis of the methodology in Rev Proc 98-34) cannot be used to value options for income tax purposes and is reserved exclusively for transfer tax purposes.

WARNING: Some commentators have warned that the IRS could take the position that a charitable deduction in connection with the transfer of an option to charity is limited by IRC§170(e)(1)(A). That section requires that, for deductibility purposes, the amount of a charitable contribution of property must be reduced by any gain that would not have been long-term capital gain if the property had been sold by the taxpayer at its fair market value on the date of contribution. In IRS Letter Ruling 9737016 (issued before Rev Proc 98-34, 1998-1 Cum Bull 983), the IRS ruled that the charitable deduction associated with the transfer of a stock option to a charity should not be reduced by the operation of IRC §170(e)(1)(A). Aside from this ruling, however, the authors are unaware of any guidance from the IRS regarding the deductibility of a transfer of an option to charity.

Just as with gifts of NQSOs to family members (see §§10.13-10.15), when the charity exercises the NQSO, the *donor* will recognize ordinary income in an amount equal to the excess of (1) the fair market value of the option shares on the exercise of the NQSO over (2) the exercise price. IRC §83(a).

NOTE: For purposes of this discussion, the authors assume that only *vested* NQSOs are transferred to a charity. Although an unvested option could be transferred, the charity could not immediately exercise it and convert it to cash. Because charities typically have a need for liquid assets with which to carry out their charitable activities, unvested options generally are not useful to them. The transfer of unvested options to a charity would be treated as a completed transfer only when the options actually vest. Rev Rul 98-21, 1998-1 Cum Bull 975.

© The Regents of the University of California

§10.30 B. Illustration: Transfer of NQSOs to Charity

Assume that an employee has a fully vested NQSO to acquire 5000 shares of Company A stock at an exercise price of $10 per share. The current fair market value of the stock subject to the option is $13 per share. For purposes of this illustration, assume that the Black-Scholes value of the option, determined in accordance with Rev Proc 98-34, 1998-1 Cum Bull 983 (see §10.21), is equal to 65 percent of the current value of the stock subject to the option.

Employee exercise of option. Assume that the employee exercises the option and immediately sells the shares. He will recognize ordinary income in the amount of the spread equal to $15,000:

5000 shares × ($13 − $10) = $15,000

Assuming a combined state and federal tax rate of 40 percent, the employee would pay $6000 in taxes and be left with an after-tax gain of $9000.

Employee transfer of option to charity. Instead of exercising the option, assume the employee transfers the option to charity. The value of the option under Rev Proc 98-34, 1998-1 Cum Bull 983, using a Black-Scholes multiplier of 0.65 would be $42,250:

0.65 × (5000 shares × $13) = $42,250

Accordingly, the employee would be entitled to a charitable deduction in the amount of $42,250. Assuming a combined state and federal tax rate of 40 percent, the after-tax benefit of the charitable deduction to the employee would be $16,900:

0.4 × $42,250 = $16,900

If the charity immediately exercises the option, the employee will recognize ordinary income in the amount of the spread, which is equal to $15,000:

5000 shares × ($13 − $10) = $15,000

Assuming a combined state and federal tax rate of 40 percent, the employee would be required to pay $6000 in taxes. After paying the taxes, the net benefit to the employee of the transfer of the option to charity is $10,900:

$16,900 − $6000 = $10,900

Comparison of exercise versus transfer. When the employee exercises and sells the shares, the after-tax benefit is $9000. When the employee transfers the option to charity, the after-tax benefit of the transfer is $10,900. However, transferring an option to charity does not always result in a larger after-tax benefit to the optionee. The size of the spread at the time of transfer, the amount of income recognized by the charity on exercise of the option, and the Black-Scholes multiplier each play a role in determining whether there is a greater after-tax benefit to exercising the option or transferring it to charity. Thus, in the example, a Black-Scholes multiplier of 55 percent (0.55 × (5000 shares × $13) = $35,750 × 0.4 = $14,300 (charitable deduction) − $6000 (combined taxes) = $8300) would result in a greater after-tax benefit from exercising the option than transferring it to charity. On the factors that influence valuation of an option, see §§10.21-10.28.

© The Regents of the University of California

§10.31 C. Securities Law Considerations

Applicable securities laws must be considered when contemplating the gift of a NQSO to a charity. Unlike shares subject to options gifted to an optionee's "family member," which can be registered on SEC Form S-8 (see §10.19), shares subject to options gifted to a public charity must be registered on the more burdensome SEC Form S-3. That form is required because public charities do not fall within the relevant definition of "family member." See Securities Act Rule 701(c)(3) (17 CFR §230.701(c)(3)). On the definition of "family member," see §10.19.

NOTE: If the company is in the process of completing its initial public offering, the shares subject to the option could be registered on the SEC Form S-1 filed in connection with the initial public offering.

The extent of the business and financial disclosure required in connection with a Form S-3 depends on the purpose for which the shares are being registered. In some situations, the extent of the business and financial disclosure is comparable to the disclosure required in the prospectus filed by a company in connection with its initial public offering. However, a substantial portion of the information required by Form S-3 may be incorporated by reference to documents previously filed with the SEC.

Only certain publicly traded companies are eligible to register shares on a Form S-3. To register shares on a Form S-3, a company (1) must have a share "float" of at least $75 million (excluding shares held by officers, directors, and shareholders owning more than five percent of the shares of the company) *or* must not sell more than one-third of its public float over any 12-month period and must not be or have been a shell company in the preceding 12 months, and (2) must have been a reporting company for at least 1 year. See "General Eligibility Requirements for Use of Form S-3" in General Instructions for Form S-3.

If the shares subject to the gifted option are not registered on a Form S-3, the shares will be subject to Securities Act Rule 144 (17 CFR §230.144) resale restrictions. Rule 144 permits shares acquired pursuant to the exercise of the gifted option to be resold only in certain limited circumstances. Among other things, the resale must occur more than at least 6 months (and in some cases, more than 1 year) after the date of purchase of the shares. See Securities Act Rule 144(d)(1) (17 CFR §230.144(d)(1)); §§9.5-9.10. Given a charity's typical need for liquidity, it may not be eager to hold shares acquired on exercise of an option for a minimum of 6 months or 1 year before it is permitted to sell them.

Because the law in this area is complex, securities counsel should be consulted in connection with any gift of stock options to charity.

© The Regents of the University of California

§10.32 VI. TRANSFER OF NQSOS TO FAMILY LIMITED PARTNERSHIP

Another planning technique that attorneys have considered in the past is the contribution or sale of NQSOs to family limited partnerships. However, in Notice 2003-47, 2003-2 Cum Bull 132, the IRS stated its intent to challenge these related-party sales of options and stated that transactions in which an optionee sells or otherwise disposes of a NQSO to a related person will be considered "listed transactions" if the sale or other disposition is in exchange for an amount that includes any deferred payment of money or property. The related person may be a family member or an entity in which the individual or members of the individual's family hold a substantial interest (such as a family limited partnership). Given the expected challenges from the IRS with respect to this technique, the contribution or sale of NQSOs to family limited partnerships no longer seems advisable.

© The Regents of the University of California

VII. TRANSFER OF NQSOS PURSUANT TO DISSOLUTION

§10.33 A. Income Tax

A marital dissolution judgment or settlement may require an employee who has been granted stock options to transfer all or a portion of the options to his or her former spouse. See, *e.g., Marriage of Steinberger* (2001) 91 CA4th 1449, 1459, 111 CR2d 521 (in marital dissolution actions, courts have broad discretion to equitably allocate community and separate property interests in employee spouse's stock options; "time rule" is appropriate method of doing so). A transfer of vested NQSOs as part of a divorce or dissolution settlement is treated as a tax-free division of marital property under IRC §1041, and neither spouse immediately recognizes gain when the transfer is made. Rev Rul 2002-22, 2002-1 Cum Bull 849. Taxpayers are treated the same whether they live in a community property state or a non-community-property state. Rev Rul 2002-22, 2002-1 Cum Bull 849. When the nonemployee spouse exercises the options, the nonemployee spouse, not the optionee, must recognize ordinary income to the extent the fair market value of the stock subject to the option exceeds the exercise price of the option (the "spread"). Rev Rul 2002-22, 2002-1 Cum Bull 849.

Consequently, on exercise of the transferred option, the company will be required to withhold the appropriate amount for income tax purposes from the nonemployee spouse. Notice 2002-31, 2002-1 Cum Bull 908, as modified by Rev Rul 2004-60, 2004-1 Cum Bull 1051. The company may treat the amount of the spread included in the income of the nonemployee spouse as supplemental wages and apply the flat rate withholding method on supplemental wages in withholding income tax on the spread. Under §101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA-2001) (Pub L 107-16, 115 Stat 38), the flat rate for withholding on supplemental wages is currently 25 percent. Because the company does not have any way of doing so, however, the company may either require the nonemployee spouse to submit a cash payment to cover the withholding obligation before allowing the option to be exercised or require the nonemployee spouse to enter into an agreement with a broker to sell a portion of the shares immediately after the exercise and submit the proceeds to the company.

© The Regents of the University of California

§10.34 B. FICA and FUTA

Transfers of options because of divorce or dissolution are treated differently for FICA (Social Security and Medicare taxes) and FUTA (federal unemployment taxes) purposes than for income tax purposes. On the exercise of a transferred stock option by the nonemployee spouse, the amount of the spread is treated as "wages" of the *optionee* for purposes of FICA and FUTA. See Notice 2002-31, 2002-1 Cum Bull 908, as modified by Rev Rul 2004-60, 2004-1 Cum Bull 1051. As a result, both the optionee and the company must include the amount of the spread as wages of the optionee in calculating the FICA and FUTA taxes due for the optionee and the company. Notice 2002-31, 2002-1 Cum Bull 908.

On exercise of the option by the nonemployee spouse, the company should withhold the appropriate amount to cover the optionee's portion of FICA or if the optionee is no longer an employee of the company or the optionee's wages are insufficient to cover the withholding obligation amount, the company should require the optionee to submit a cash payment in the requisite amount. In addition, the company should pay its portion of FICA and FUTA to the IRS based on the spread, taking into account other wages the optionee has received from the company during the calendar year. Notice 2002-31, 2002-1 Cum Bull 908, as modified by Rev Rul 2004-60, 2004-1 Cum Bull 1051.

© The Regents of the University of California

§10.35 C. Reporting Obligations

When an employee transfers stock options to a former spouse, the following reporting obligations arise:

Reporting for optionee. The company should issue a Form W-2 to the optionee showing the spread as wages for FICA purposes in the appropriate boxes. The Form W-2 should not report as wages the amount of the spread for income tax purposes (see §10.33) and, therefore, Boxes 1 and 2 of the Form W-2 should not include the amount of the spread. Notice 2002-31, 2002-1 Cum Bull 908, as modified by Rev Rul 2004-60, 2004-1 Cum Bull 1051.

Reporting for nonemployee spouse. Because the nonemployee spouse is not an employee of the company, the amount of the spread should be reported on a Form 1099-MISC in Box 3 as other income with the amount withheld reported in Box 4. See §10.33. The company should obtain a Form W-9 from the nonemployee spouse. The nonemployee spouse should be required to notify the company of any change to the address indicated in the Form W-9. Notice 2002-31, 2002-1 Cum Bull 908, as modified by Rev Rul 2004-60, 2004-1 Cum Bull 1051.

Reporting for company. The company should report any amounts it withheld from the nonemployee spouse on Form 945. See §10.33. Any FICA taxes that were withheld or paid by the company should be reported on Form 941, and any FUTA taxes that were paid by the company should be reported on Form 940. Notice 2002-31, 2002-1 Cum Bull 908, as modified by Rev Rul 2004-60, 2004-1 Cum Bull 1051.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/10 Estate Planning With Compensatory Stock Options/ D. Other Issues/§10.36 1. ISOs Transferred to Former Spouse

D. Other Issues

§10.36 1. ISOs Transferred to Former Spouse

Incentive stock options can only be issued to and held by employees who are employees for up to 3 months before exercise of the option. IRC §422(a)(2). Therefore, in order for an optionee to transfer an ISO to a former spouse, the option must be amended to:

- Convert the ISO to a NQSO; and
- Permit the transfer of the option to the optionee's former spouse.

© The Regents of the University of California

§10.37 2. Optionee Exercise of Option on Behalf of Nonemployee Spouse

A judgment of dissolution sometimes will provide that, rather than transferring options to the nonemployee spouse, the optionee will continue to hold the options on behalf of the nonemployee spouse and will exercise them and transfer the shares at the direction of the nonemployee spouse. In that situation, the optionee will be subject to the same income tax, withholding, FICA, and reporting rules as if he or she had exercised the options on his or her own behalf. See §§10.33-10.35. Assuming that the transfer of shares occurs at the time of the exercise of the option, and the option is a nonqualified option, the optionee will not recognize gain or loss on the transfer of the shares to the nonemployee spouse because the optionee's basis will be equal to the fair market value of the shares. See §10.33. If the transfer does not occur concurrently with the exercise of the option, or the option is an ISO, the optionee may be required to recognize gain or loss unless either (a) the transfer of shares occurs within 1 year of the dissolution becoming final (see Treas Reg 1.1041-1T(b), Q&A-6), or (b) the transfer of shares is pursuant to a dissolution or separation agreement and occurs within 6 years of the dissolution becoming final (see Treas Reg 1.1041-1T(b), Q&A-7).

© The Regents of the University of California

§10.38 E. Checklist: Company's Responsibilities Regarding Transfer of Options to Nonemployee Spouse

▶ To download **Word** version, right click and choose *Save Target As*

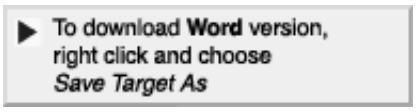
▶ To download **WordPerfect** version, right click and choose *Save Target As*

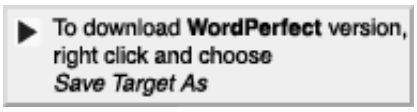
When an optionee wishes to transfer options to a nonemployee spouse, the company that issued the options should take the following steps:

- Before allowing the transfer, the issuing company should require both the optionee and the nonemployee spouse to sign a Consent and Tax Indemnity Agreement (see form in §10.39). The Consent and Tax Indemnity Agreement form provides that:
- Both the optionee and the nonemployee spouse consent to the transfer;
- They understand the tax ramifications of the transaction (which are described in the Consent and Tax Indemnity Agreement); and
- They will jointly and severally hold the company harmless for any tax liabilities, penalties, or interest it incurs as a result of the transfer and subsequent exercise.
- When the nonemployee spouse exercises the option, the issuing company, before delivering the shares, should:
- Require the nonemployee spouse to deliver to the company an amount of cash sufficient to satisfy the exercise price of the option as well as any income tax withholding amounts required for both federal and state tax purposes (or have the nonemployee spouse enter into an agreement with a broker to sell a portion of the shares immediately after the exercise to cover the withholding obligation and submit the proceeds to the company);
- Make sure that it has obtained a Form W-9 from the nonemployee spouse and require the nonemployee spouse to notify the company of any change to the address indicated in the Form W-9.
- Withhold from the optionee's wages an amount necessary to satisfy the FICA tax obligation on the exercise (in the event the optionee is no longer employed by the company or the optionee does not have enough wages to withhold the entire amount, the company should require a cash payment from the optionee to cover any shortfall); and
- Prepare and send all appropriate forms to the optionee, the nonemployee spouse, and the IRS within the proscribed time periods.

© The Regents of the University of California

§10.39 F. Form: Option Transfer, Consent, and Indemnity Agreement





10.39-1 Option transfer, consent, and indemnity agreement

Option Transfer, Consent, and Tax Indemnity Agreement

This option transfer, consent, and tax indemnity agreement (the "Agreement") is entered into between _ _[*name of company*]_ _ ("Company"), _ _[*name of employee*]_ _ ("Employee"), and _ _[*name*]_ _ ("Nonemployee Spouse") (collectively the "Parties") as of _ _[*date*]_ _.

Whereas, on _ _[*date*]_ _, Company granted to Employee options ("Options") to purchase _ _[*number*]_ _ shares of Company common stock under the terms of the _ _[*name of plan*]_ _ Plan (the "Plan") and a stock option award agreement (the "Award Agreement"), and

Whereas, on _ _[*date*]_ _, Employee and Nonemployee Spouse _ _[*legally dissolved their marriage/were legally divorced*]_ _, and

Whereas, under the _ _[*marital dissolution/divorce*]_ _ property settlement, Employee agreed to transfer Options to purchase _ _[*number*]_ _ shares of Company common stock to Nonemployee Spouse,

Now, therefore, the Parties agree as follows:

1. As of the date of this Agreement, Employee is a resident of the state of _ _[*name of state*]_ _, and Nonemployee Spouse is a resident of the state of _ _[*name of state*]_ _.

2. Employee instructs the Company to transfer Options to purchase _ _[*number*]_ _ shares of Company common stock granted to Employee under the option agreement dated _ _[*date*]_ _ (the "Transferred Options") to Nonemployee Spouse, and Nonemployee Spouse accepts the transfer of the Options. Nonemployee Spouse agrees to be bound by all the terms and conditions of the Transferred Options.

3. Nonemployee Spouse agrees to pay all state and federal income taxes that arise as a result of the exercise of the Transferred Options and agrees to satisfy all required income tax withholding with respect to such income taxes by either (a) submitting a payment to the Company that will be sufficient to satisfy the withholding obligation, or (b) entering into an agreement with a broker to sell a portion of the shares acquired pursuant to the exercise of the Transferred Options immediately after the exercise to cover the withholding obligation and submitting the proceeds to the Company.

4. The Company will issue a Form 1099 to Nonemployee Spouse for the year in which Nonemployee Spouse exercises any Transferred Options. The amount included on Form 1099 will equal the difference between the fair market value of Company common stock on the date of the exercise and the exercise price. Nonemployee Spouse agrees to complete and return to the Company the Form W-9 attached to this Agreement, and to notify the Company upon any change in his or her residence address indicated in the Form W-9.

5. All taxes imposed under Internal Revenue Code §§3121-3128 (FICA taxes) and any state employment taxes that arise as a result of the exercise of the Transferred Options, other than the Company's portion, will be withheld from Employee's wages provided that Employee is an employee of the Company on the date of exercise. In addition, the Company may withhold from Employee's wages any foreign, federal, state, or local income and employment tax the Company determines that it is legally required to withhold in connection with the transfer or exercise of the Transferred Options. If Employee is not employed by the Company on the date the Transferred Option is exercised, or if Employee's wages are not sufficient to satisfy the required withholding amount, Employee will be required to submit a payment to the Company in an amount equal to the FICA taxes and any foreign, federal, state, or local income and employment tax that the Company determines it

is legally obligated to withhold from Employee as a result of the exercise, before the Company delivers any shares to Nonemployee Spouse. If Employee does not submit to the Company the necessary funds to satisfy all of Employee's tax withholding obligations contained in this Agreement, Nonemployee Spouse will be required to submit a payment to the Company in an amount equal to the obligations before the Company delivers any shares to Nonemployee Spouse. In addition, if Nonemployee Spouse submits such a payment, the Company will have no obligation to attempt to collect any unpaid amounts from Employee, and any collection efforts or remedies are the sole responsibility of Nonemployee Spouse.

6. Employee and Nonemployee Spouse agree jointly and severally to pay on demand, indemnify, and hold harmless the Company on an after-tax basis with respect to any taxes, interest, or penalties the Company may incur as a result of the exercise or transfer of the Transferred Options, excluding the Company's portion of FICA taxes and the taxes imposed under Internal Revenue Code §§3301-3309 (FUTA taxes).

7. Employee and Nonemployee Spouse agree and acknowledge that it will be Employee's sole responsibility to provide written notice to Nonemployee Spouse of Employee's termination of employment or service with the Company. Employee and Nonemployee Spouse agree that such notice by Employee is adequate to apprise Nonemployee Spouse of Employee's termination of employment or service, and that the Company has no obligation to separately provide notice of termination of employment or service to Nonemployee Spouse. As a condition to the transfer of the Transferred Options, and as partial consideration from Nonemployee Spouse to the Company for the transfer of the Transferred Options, Nonemployee Spouse agrees to rely solely on Employee for notice of Employee's termination of employment or service with the Company. Further, Nonemployee Spouse acknowledges that the ability to exercise the vested Transferred Options will terminate (a) 3 months after Employee's termination of employment or service with the Company for any reason other than death or disability, or (b) 12 months after Employee's termination of employment or service with the Company as a result of death or disability.

8. This Agreement constitutes the entire agreement of the Parties with respect to the subject matter and supersedes all prior undertakings and agreements of the Parties with respect to the subject matter. This Agreement may not be modified except by a writing signed by the Company, the Employee, and the Nonemployee Spouse. Nothing in this Agreement is intended to confer any rights or remedies on any persons other than the Parties.

9. The Agreement is to be construed in accordance with and governed by the internal laws of the State of California, without giving effect to any choice of law rule that would cause the application of the laws of any jurisdiction other than the internal laws of the State of California, to the rights and duties of the Parties. Should any provision of this Agreement be determined by a court of law to be illegal or unenforceable, the provision will be enforced to the fullest extent allowed by law, and the other provisions will nevertheless remain effective and enforceable.

10. The Parties will attempt in good faith to resolve any disputes arising out of or relating to this Agreement by negotiation between individuals who have authority to settle the controversy. Negotiations will be commenced by any Party by notice to all other Parties of a written statement of the Party's position and the name and title of the individual who will represent the Party. Within 30 days of the written notification, the Parties will meet at a mutually acceptable time and place, and thereafter as often as they reasonably consider necessary, to resolve the dispute. If the dispute has not been resolved by negotiation, the Parties agree that any suit, action, or proceeding arising out of or relating to this Agreement will be brought in _ _[*e.g., the United States District Court for the Northern District of California (or should that court lack jurisdiction, in a California state court in the County of* _ _[*name of county*]_ _)]_ _, and that the Parties will submit to the jurisdiction of such court. Each Party irrevocably waives, to the fullest extent permitted by law, any objection he or she may have to the laying of venue for any such suit, action, or proceeding. If any one or more provisions of this Section 10 are for any reason held invalid or unenforceable, it is the specific intent of the Parties that the invalid provision be modified to the minimum extent necessary to make it or its application valid and enforceable.

11. This Agreement may be executed in one or more counterparts.

Date: _____ **_____,**
By: _____
Its: _____

Date: _____ **_____**
Employee

Date: _____

_____

Nonemployee Spouse

© The Regents of the University of California

VIII. DISPOSITION OF STOCK OPTIONS ON DEATH OF OPTIONEE

A. Exercise of Stock Options by Estate or Heir

§10.40 1. ISOs

The right to exercise an ISO and to receive the preferential tax treatment (see §10.5) is not lost on the death of the optionee. The option plan or the applicable stock option agreement may specifically provide for exercise of the ISO by the employee's estate or by anyone who has acquired the ISO by devise or inheritance from the employee or otherwise by reason of the employee's death. See Reg §§1.421-1(b)(2), 1.421-2(c). For example, the optionee may designate a beneficiary of the option pursuant to a beneficiary designation form. See form in §10.43.

Under Reg §1.421-2(c)(1), the same rules will apply to exercise of an ISO by the estate or the heir as would have applied to the deceased optionee, with two exceptions:

- The estate or heir will not be subject to the ISO holding period that would have required the deceased optionee to hold the stock for the longer of (a) two years from the date when the ISO is granted, or (b) one year from the date when the shares are issued on exercise of the ISO. IRC §421(c)(1)(A). Therefore, the estate or heir will still receive favorable tax treatment even if a disposition of the shares occurs before the satisfaction of the holding period specified in IRC §422(a)(1). However, the applicable capital gains holding periods will still apply for purposes of determining whether the gain or loss on disposition of the stock will be subject to long-term or short-term capital gains treatment. Reg §1.421-2(c)(1). Therefore, the shares will have to be held for more than one year to receive long-term capital gain treatment. See §10.5.
- As long as the deceased employee met the employment requirements specified in IRC §422(a)(2) at the time of his or her death, the employment requirements for ISOs will be satisfied and will not need to be separately met by the estate or heir. In other words, there is no requirement that the deceased employee's estate or heir exercise the ISO within three months of the employee's death. Reg §1.421-2(c)(1). The ISO could be exercised until the applicable expiration date of the ISO. However, the terms of the stock option agreement typically provide that an ISO is exercisable for a period of 12 months following the death of the optionee.

The transfer of ISO stock from the deceased optionee to the estate or the heir of the optionee will not be a disposition of the stock. Reg §1.421-2(c)(1). The ISO holding period also will not apply to stock obtained directly from a deceased employee who had exercised the ISO during his or her lifetime but died before the expiration of the applicable ISO holding period. Reg §1.421-2(d).

© The Regents of the University of California

§10.41 2. NQSOs

An option plan or stock option agreement may specifically provide for the exercise of the NQSO by the estate of the employee or by anyone who has acquired the NQSO by devise or inheritance from the employee or in some other way due to the employee's death. See Reg §§1.421-1(b)(2), 1.421-2(c). For example, the optionee may designate a beneficiary of the option pursuant to a beneficiary designation form. See form in §10.43.

Nonqualified stock options constitute income in respect of a decedent. See IRC §2033. On exercise of the option by the estate, ordinary income will be recognized in an amount equal to the difference between the fair market value of the shares subject to the NQSO on the date of exercise and the exercise price of the option. The ordinary income will not be subject to withholding for income taxes. See Rev Rul 86-109, 1986-2 Cum Bull 196. The ordinary income will be subject to withholding for FICA (Social Security and Medicare taxes). However, if the exercise of the NQSO occurs after the calendar year in which the employee died, the ordinary income will not be subject to withholding for FICA and FUTA. IRC §§3121(a)(14), 3306(a)(15).

At the date of exercise, a new holding period begins, and a new basis is taken equal to the fair market value of the shares on the date of exercise. Any gain or loss on subsequent disposition of the shares will be treated as long- or short-term capital gain depending on whether the shares were held for more than one year. See §10.5.

© The Regents of the University of California

§10.42 B. Beneficiary Designation

As discussed in §§10.40-10.41, both ISOs and NQSOs may be transferred at death by beneficiary designation. The California Probate Code specifically recognizes the nonprobate transfer at death of certain assets, including a compensation plan or employee benefit plan. Such a nonprobate transfer is not required to comply with the requirements for the execution of a will. Prob C §5000(a). A stock option beneficiary designation form is set forth in §10.43.

A married optionee whose options are community property may dispose only of his or her community property interest in the options. See Prob C §100(a). The optionee's spouse may either (1) consent to the optionee's designation (see §10.43), or (2) complete a separate beneficiary designation indicating the beneficiary of his or her community property interest in the options. See Prob C §100(b).

© The Regents of the University of California

§10.43 C. Form: Stock Option Beneficiary Designation

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

10.43-1 Stock option beneficiary designation

_____
[*Name of company*]

Stock Option Beneficiary Designation

Optionee's Name: _____
Address:_____
Spouse's Name:_____
[ ] Incentive [ ] Nonqualified Stock Option
Grant No._____
Stock Incentive Plan: _ _[*name of plan*]**_ _**
Date of Grant:_____
Number of shares granted:_____

[*Add one of the following alternatives before giving form to optionee*]

[*Alternative 1: Beneficiary designation for single option grant*]

In the event of my death before the exercise of the Option, and in lieu of disposing of my interest in the Option by my will or the laws of intestate succession, I designate the following person(s) as Primary and Contingent Beneficiary(ies) of my interest in the Option:

[*Alternative 2: Beneficiary designation for all options granted to optionee*]

In the event of my death before the exercise of my currently outstanding or subsequently issued stock options (the "Options"), under any existing or subsequently adopted stock incentive or option plan of _ _[*name of company*]**_ _ or its successor in interest (the "Company") (whether adopted by the Company or assumed by the Company in connection with a merger, acquisition, or other similar transaction) or granted to me by the Company outside of any such stock plan, and in place of disposing of my interest, if any, in the Options at the time of my death by my will or the laws of intestate succession, I designate the following person(s) as Primary and Contingent Beneficiary(ies) of my interest in the Options. Notwithstanding the foregoing, this Beneficiary Designation will not apply to any purchase rights granted under an employee stock purchase plan qualified under Internal Revenue Code §423 or any substantially equivalent stock purchase plan.**

[*Continue*]

***Primary Beneficiaries*: (Please select only one of the three alternatives)**

1. [ ] Individual or Charity

Name: _____ Percent share _____

Address: _____

Name:_____ Percent share _____

Address: _____

Name: _____ Percent share _____

Address: _____

2. [ ] Living Trust

_______[*print name of present trustee*]**, or any successor, as Trustee of the _____**__[*print name of trust*]**, dated _____**__[*fill in date trust was established*]**.**

3. [ ] Residuary Testamentary Trust

In trust, to the trustee of the trust named as the beneficiary of the residue of my probate estate.

***Contingent Beneficiaries*: (Please select only one of the three alternatives)**

1. [ ] Individuals and/or Charities

Name: _____ Percent share _____

Address: _____

Name:_____ Percent share _____

Address: _____

Name: _____ Percent share _____

Address: _____

2. [ ] Living Trust

_______[*print name of present trustee*]**, or any successor, as Trustee of the _____**__[*print name of trust*]**, dated _____**__[*fill in date trust was established*]**.**

3. [ ] Residuary Testamentary Trust

In trust, to the trustee of the trust named as the beneficiary of the residue of my probate estate.

If any individual Primary Beneficiary fails to survive me, or if a charity named as a Primary Beneficiary no longer exists at my death, that beneficiary's share will be divided among the remaining named Primary Beneficiaries, in proportion to the percentage shares I have allocated to them. If all the individual Primary Beneficiary(ies) fail to survive me, or if the trust named as the Primary Beneficiary does not exist at my death (or no will of mine containing a residuary trust is admitted to probate within 6 months of my death), the Contingent Beneficiary(ies) will be entitled to my interest in the Option(s) for the shares indicated. If any individual Contingent Beneficiary fails to survive me, or if a charity named as a Contingent Beneficiary no longer exists at my death, that beneficiary's share will be divided among the remaining named Contingent Beneficiaries, in proportion to the percentage shares I have allocated to them. If no Individual Primary or Contingent Beneficiary survives me, no trust (excluding a residuary testamentary trust) or charity named as a Primary or Contingent Beneficiary exists at my death, and no will of mine containing a residuary trust is admitted to probate within 6 months of my death, then my interest in the Option(s) will be disposed of by my will or the laws of intestate succession, as applicable.

This Beneficiary Designation is effective until I file another such designation with _ _[*name of company*]_ _. Any previous Beneficiary Designations are revoked.

Submitted by:

Date: _ _ _ _ _ _ __[*Signature of optionee*]__

_ _[*Typed name*]_ _**, Optionee**

Date: _ _ _ _ _ _ __[*Signature of optionee's spouse*]__
_ _[*Typed name*]_ _**, Optionee's Spouse**

Accepted by:

Date: _ _ _ _ _ _ _ _[*NAME OF ENTITY*]_ _**,**
a _ _[*specify entity, e.g., California corporation*]_ _

By: __[*Signature*]__
Name: _ _[*Typed name*]_ _
Its: _ _[*Title*]_ _

[*Optionee's spouse should file separate beneficiary designation for the spouse's community property interest in the option(s)*]

Comment: This beneficiary designation can be executed for (1) a single stock option (see Alternative 1) or (2) all stock options whether currently outstanding or subsequently issued (see Alternative 2). The attorney should choose Alternative 1 or 2 before the document is distributed to the optionee to be completed.

A married optionee may dispose only of his or her community property interest in the options. See Prob C §100(a). The optionee's spouse may complete a separate beneficiary designation disposing of his or her community property interest in the options.

© The Regents of the University of California

§10.44 IX. APPENDIX: EXAMPLE OF TAX CALCULATIONS FOR SINGLE TAXPAYER ON EXERCISE AND SALE OF ISO

NOTE: The tax calculations in the following example are for illustration purposes only. The calculations are based on tax rates and exemption amounts for the year 2009. The example does not take into account any phase-out of the federal exemption amount based on the income level of the taxpayer nor does it include any California state taxes that would occur as a result of the exercise of the ISO.

Taxpayer Assumptions

Marital Status:		Single
Annual Salary:		$126,350
401K Contribution:		$16,500
Federal Tax Exemptions:		$3,650
Federal Itemized Deductions:		
CA State Taxes:	$6,250	
Home Mortgage Interest:	$20,000	
Charitable Contributions:	$2,400	
Total Itemized Deductions:		$28,650
Regular Taxable Income:		$77,550

On January 1, 2001, the grant date of the ISO, the fair market value of the common stock is $19 per share. On January 15, 2008, the exercise date, 3000 shares of common stock are exercised when the fair market value is $60 per share.

Qualifying Disposition

On March 1, 2009, the shares are sold for $70 per share.

Because the sale of the shares is made (a) more than 2 years after the grant date of the ISO, and (b) more than 1 year after the exercise date, the sale is a qualifying disposition, and for federal income tax purposes the taxpayer's gain will be divided into two components (see §10.5):

Alternative minimum tax (AMT). The "spread" (the difference between the fair market value of the shares at exercise ($60) and the exercise price ($19) is classified as an item of adjustment in 2008 for purposes of AMT. The AMT income attributable to the ISO exercise is $123,000 (3000 shares multiplied by the spread of $41 per share).

Long-term capital gain. In 2009, the taxpayer will recognize a long-term capital gain of $51 per share, which is the excess of the $70-per-share selling price over the basis in the shares ($19 exercise price).

Federal tax liability. The taxpayer has regular taxable income of $77,550. The regular tax on that income is approximately $12,052. To determine the taxpayer's AMT liability, this regular taxable income must be increased by certain items includible in the AMT calculation. For the taxpayer, the items include the following:

ISO spread:	$123,000
CA state taxes:	$6,250
Total:	$129,250

Therefore, the taxpayer's total AMT income equals $206,800 ($77,550 regular taxable income plus $129,250 additional AMT items).

A specified amount of AMT income is exempt from AMT. The exemption amount varies according to a taxpayer's filing status and is subject to a phase-out for taxpayers with high AMT income. The exemption for a single taxpayer is

$46,200 (for the 2008 taxable year; IRC §55(d)(1)(B)), but the exemption for a single taxpayer is reduced by 25 percent of the amount that the AMT income exceeds $112,500 (IRC §55(d)(3)). Accordingly, the taxpayer's exemption is reduced to $22,625 ($46,200 − (($206,800 − 112,500) × 0.25) = $22,625). After subtracting the exemption amount, the net AMT income for the taxpayer is $184,175.

The first $175,000 of AMT income is taxable at a 26-percent rate. IRC §55(b)(1)(A)(i)(I). Any amount in excess of $175,000 is taxable at a 28-percent rate. IRC §55(b)(1)(A)(i)(II). Accordingly, the taxpayer's total AMT liability is $48,069 (26 percent of $175,000 plus 28 percent of $9175).

Because the taxpayer's AMT liability exceeds his regular income tax liability, he must pay AMT in the total amount of $48,069. Without the ISO exercise, the taxpayer's regular income tax liability would have been $12,052. The exercise of the ISO created $36,017 of additional tax liability for the taxpayer.

California tax liability. Federal and California AMT operate in a similar fashion. The California AMT rate is 7.25 percent on all AMT income. Rev & T C §17062(b)(3)(A)(iii).

The California AMT exemption for a single taxpayer for taxable year 2008 is $60,014 (adjusted annually for inflation). A phase-out reduces the exemption by 25 percent of the amount AMT income exceeds $225,050 (for taxable year 2008, adjusted annually for inflation). Rev & T C §17062(b)(5)(B), (b)(6)(B), (b)(7). Therefore, the taxpayer's AMT exemption would not be subject to reduction.

Disqualifying Disposition—Same Calendar Year

On June 1, 2008, the taxpayer sells the shares for $65 per share. Because the disposition of the shares is made less than 1 year after the exercise date, the sale represents a disqualifying disposition of the shares (see §10.5), and for federal income tax purposes the gain on the sale will be divided into two components:

Ordinary income. The taxpayer will recognize ordinary income in the amount of $41 per share, the excess of the $60-per-share market value of the shares on the exercise date over the $19-per-share exercise price. The total ordinary income recognized by the taxpayer is $123,000.

Short-term capital gain. The taxpayer will also recognize a short-term capital gain of $5 per share, the excess of the $65-per-share selling price over the $60-per-share market value on the exercise date. The total short term capital recognized by the taxpayer is $15,000.

Because the shares were sold within the same calendar year in which the ISO was exercised, there is no AMT liability associated with the exercise of the ISO.

Federal tax liability. The taxpayer has regular taxable income of $77,550, and the regular tax on that income is $12,052. The disqualifying disposition of the shares results in an additional $138,000 of regular taxable income in 2008 ($123,000 ordinary income and $15,000 short-term capital gain). Accordingly, the taxpayer's total regular taxable income is $215,550. The regular tax on that income is approximately $56,882.

As a result of the disqualifying disposition of the shares, the taxpayer must pay tax in the total amount of $56,882. Without the disqualifying disposition, the taxpayer's income tax liability would have been $12,052. The exercise of the ISO and disqualifying disposition of the shares created $44,830 of additional regular tax owed by the taxpayer. Compare this to the $36,017 of AMT tax liability that was generated by the exercise of the ISO under a qualifying disposition.

California tax liability. The disqualifying disposition of the shares results in an additional $138,000 of regular taxable income in 2008 ($123,000 ordinary income and $15,000 short-term capital gain) that would be subject to California state income tax.

Disqualifying Disposition—Different Calendar Year

On January 5, 2009, the taxpayer sells the shares for $65 per share. Because the disposition of the shares is made less than 1 year after the exercise date, the sale represents a disqualifying disposition of the shares. See §10.5. The disqualifying disposition of the shares results in an additional $138,000 of regular taxable income in 2009.

However, because the shares were not disposed of during the same calendar year in which the exercise of the ISO occurred, the taxpayer would also have federal and California AMT liability in 2008. Thus, it is important to note that if a disqualifying disposition occurs in the calendar year after the year when the ISO was exercised, the option holder may be subject to both federal and California AMT in the year of exercise *and* ordinary income tax in the subsequent year of disposition.

Finally, under both federal and California tax law, the taxpayer may be able to claim a tax credit in 2009 for the AMT paid in 2008. The calculation of the credit is complex, and it is not certain that the total amount of AMT paid in 2008 may be used as a credit against tax due in 2009. Unused AMT credit may be carried forward indefinitely.

© The Regents of the University of California

11

Planning for Disposition of a Law Practice

Marshal A. Oldman
Frayda L. Bruton

I. INTRODUCTION
- A. Scope of Chapter §11.1
- B. Closing a Practice Under State Bar Act §11.2
- C. Closing a Practice Under the Probate Code §11.3

II. PETITION FOR APPOINTMENT OF PRACTICE ADMINISTRATOR
- A. Who May Bring Petition §11.4
- B. Notice of Petition §11.5
- C. Contents of Petition §11.6
- D. Powers and Duties of Practice Administrator §11.7
- E. Forms
  - 1. Form: Petition for Appointment of Practice Administrator §11.8
  - 2. Form: Order Appointing Practice Administrator §11.9

III. PRACTICE ADMINISTRATOR: PRACTICAL CONSIDERATIONS
- A. Nomination of Practice Administrator §11.10
  - 1. Agreements to Take Control of a Practice §11.11
  - 2. Form: Nomination of Practice Administrator §11.12
- B. Acting as Practice Administrator §11.13
  - 1. Considerations in Disposing of Law Practice §11.14
  - 2. Fee Allocation Problems §11.15

© The Regents of the University of California

I. INTRODUCTION

§11.1 A. Scope of Chapter

The focus of this chapter is on planning for the disposition of the practice of a solo practitioner who is no longer able to practice due to death or disability. It assumes that partnerships or other practices consisting of multiple attorneys capable of assuming the burden of a deceased or disabled partner will have developed their own plans for disposing of a practice independent of the State Bar Act (Bus & P C §§6000-6238, particularly §§6180-6190.6) and the provisions for the appointment of a practice administrator (Prob C §§2468, 9764, 17200(b)(22)-(23)).

Traditionally when an attorney died or became disabled without making arrangements for his or her practice, the superior court would assume jurisdiction over the attorney's practice under Bus & P C §§6180-6180.14 and appoint one or more active State Bar members to review the files, contact the clients, and help arrange for the designation of successor counsel. The appointed attorney is a volunteer and is not allowed to become the successor attorney for any of the cases. Consequently, the State Bar system is not focused on preserving the value of the practice for the estate of the deceased or disabled member, and a lifetime's work can be lost within a short period of time. See §11.2.

The Trust and Estates Section of the State Bar formed a task force during the 1990s to help solo practitioners protect the value of their practices if no arrangements had been made to dispose of the practice before death or disability occurred. Initially, the focus was on drafting proposed "buddy agreements" that would provide for an attorney chosen by the practitioner to take control at the proper time. However, problems with confidentiality and notification of the practitioner's clients plagued attempts to draft model agreements that could be circulated to attorneys for their own use. Ultimately, a legislative solution was sought that would allow the superior court to appoint a person to take control of a deceased or disabled member's practice with the objective of preserving the value of the practice for the estate. Consequently, and with the greatly helpful input of members of the State Bar trial court, the legislature enacted Bus & P C §6185 and Prob C §§2468 and 9764, and amended Prob C §17200. Stats 1998, ch 682. See §11.3.

© The Regents of the University of California

§11.2 B. Closing a Practice Under State Bar Act

Business and Professions Code §§6180 and 6190-6190.1 authorize the State Bar to petition the court to take control of a member's files in order to protect the interests of the member's clients in case of death or disability or neglect of the interests of the clients if no other member is available to take control of the files. If the disabled attorney consents to the superior court's jurisdiction, a client or any interested party or entity may also apply to the superior court. Bus & P C §6190.1(b).

The focus of such a proceeding is to protect clients, not to protect the value of a member's practice. The volunteer attorney appointed by the court to assist clients with finding new counsel is not permitted to become successor counsel, but is authorized to appear on behalf of clients to obtain extensions of time and continuances so that new counsel can be retained. Bus & P C §§6180.5, 6180.7, 6190.4. On completion of the proceeding, the member's files will be returned to the clients or sent to successor counsel. Bus & P C §6180.5(d). The remaining assets of the firm will be subject to the control of the member's personal representative or conservator. However, this procedure makes no provision for obtaining any value for the goodwill of the member's practice as a continuing business.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/§11.3 C. Closing a Practice Under the Probate Code

§11.3 C. Closing a Practice Under the Probate Code

Parallel statutes that authorize the filing of a petition to appoint a practice administrator to take control of the files and assets of a deceased or disabled attorney were added to the Probate Code in:

- Prob C §2468 for a disabled attorney under conservatorship;
- Prob C §9764 for a deceased member whose estate is subject to administration; and
- Prob C §17200(b)(22)-(23) when the economic interest of a practice has been transferred to a living trust and a trust proceeding is preferred to either a decedent estate or conservatorship.

Under all three Probate Code sections, the procedure for the appointment of a practice administrator is the same notwithstanding which code section is applicable to a particular proceeding. Probate Code §17200(b)(22)-(23) explicitly refers to the procedures under Prob C §9764 for deceased members and Prob C §2468 for disabled members respectively.

© The Regents of the University of California

II. PETITION FOR APPOINTMENT OF PRACTICE ADMINISTRATOR

§11.4 A. Who May Bring Petition

A petition may be brought for the appointment of a practice administrator by the personal representative, conservator, or other person interested in the estate of the deceased or disabled member. The petition must seek the appointment of an active member of the State Bar who will be appointed to take control of both the assets and files of the deceased or disabled member's practice. Prob C §§2468(a), 9764(a), 17200(b)(22)-(23).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/§11.5 B. Notice of Petition

§11.5 B. Notice of Petition

Notice of the petition may be waived if it is alleged that the immediate appointment of a practice administrator is required to protect the assets of the practice or its clients, and the personal representative, conservator, or trustee has either petitioned, joined in the petition, or has waived notice. Otherwise, the court shall prescribe the notice period that it deems appropriate in its discretion. Prob C §§2468(b), 9764(b), 17200(b)(22)-(23).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/§11.6 C. Contents of Petition

§11.6 C. Contents of Petition

The petition must specify the powers sought for the practice administrator from the powers listed in Bus & P C §6185. The proposed order appointing the practice administrator must specify the same powers requested by the petition. Prob C §§2468(c), 9764(c), 17200(b)(22)-(23).

The petition must estimate the value of the assets of the member's practice, including any accounts used by the member, that are to come into the possession of the practice administrator. A surety bond for the amount of the assets must be posted by the practice administrator, and no action may be taken by the practice administrator until the bond has been filed with the court. Prob C §§2468(d), 9764(d), 17200(b)(22)-(23).

The practice administrator may not be the attorney representing the personal representative, conservator, or trustee. The court will appoint the person nominated by the member to act as practice administrator, however, unless the court concludes that the appointment would be contrary to the best interests of the estate or would create a conflict of interest with any of the clients of the deceased or disabled member. Prob C §§2468(e)-(f), 9764(e)-(f), 17200(b)(22)-(23). For form for nomination of practice administrator, see §11.12.

NOTE: Even if the practice of a deceased or disabled member is a sole proprietorship and the assets of the practice would normally be marshaled by the personal representative, conservator, or trustee, a practice administrator has the right to take control of the assets of the practice, assuming that power to do so is granted by the court. For this reason, the practice administrator is bonded separately from the fiduciary in charge of the estate and will need to account for the assets under his or her control. Client files, however, are not counted as assets of the practice. The client files are owned by the clients and cannot be held by the practice administrator without the client's consent. Trust account deposits beyond the amounts needed to pay client obligations for costs and fees owed to the deceased member are also not considered assets of the practice because any unused portion must be returned to the client.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/§11.7 D. Powers and Duties of Practice Administrator

§11.7 D. Powers and Duties of Practice Administrator

Business and Professions Code §6185(a) lists the powers and duties of the practice administrator. The powers desired by the practice administrator must be listed in the petition for appointment, and the powers ultimately granted by the court must be listed in the order of appointment. Prob C §§2468(c), 9764(c), 17200(b)(22)-(23). See §11.6.

The powers that may be granted under Bus & P C §6185(a) include the power to:

- Take control of all operating and client trust accounts, business assets, equipment, client directories, and premises that were used in the conduct of the deceased or disabled member's practice;
- Take control and review all client files of the deceased or disabled member;
- Contact each client of the deceased or disabled member who can be reasonably ascertained and located to inform the client of the condition of the member and of the appointment of a practice administrator; the practice administrator may discuss various options for the selection of successor counsel with the client;
- In each case that is pending before any court or administrative body, notify the appropriate court or administrative body and contact opposing counsel in the cases under the control of the deceased or disabled member and obtain additional time for new counsel to appear for the affected client;
- Determine the liabilities of the practice and pay them from the assets of the practice;
- Employ any person, including but not limited to the employees of the deceased or disabled member, who may be necessary to assist the practice administrator in the management, winding up, and disposal of the practice;
- Create a plan for disposition of the practice of the deceased or disabled member to protect its value as an asset of the member's estate;
- Subject to the approval of the estate's personal representative, agree to the sale of the practice and its goodwill;
- Subject to the approval of the personal representative of the estate, reach agreements with successor counsel for division of fees for work in process on the cases of the deceased or disabled member; and
- Subject to the prohibitions against soliciting cases, act as successor counsel for a client of the deceased or disabled member.

Normally, the practice administrator will seek all of the powers available under Bus & P C §6185(a). However, the powers that focus primarily on the running of a business may be more narrowly requested if the deceased or disabled member did not have a business with separate accounts, premises, and employees. Most of the time, the member will be in semi-retirement with a few remaining cases that require representation at the time of death or disability. The files may also include a number of testamentary instruments that the attorney is holding for clients with the expectation that some of them might develop into a probate or trust administration. In such instances, the role of the practice administrator may be largely limited to resolving the few active cases and finding the clients for whom documents are being held.

The practice administrator must also consider the size of the bond on court appointment. Seeking limited powers may result in little or no bond and a subsequent savings to the estate and the practice.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/ E. Forms/ §11.8 1. Form: Petition for Appointment of Practice Administrator

E. Forms

§11.8 1. Form: Petition for Appointment of Practice Administrator

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

11.8-1 Petition for appointment of practice administrator

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
Attorney for petitioner, _ _[*name*]_ _

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF _ _ _ _ _ _

[*Use one of the following alternatives*]

[*Alternative 1: Appointment of practice administrator for deceased member*]

Estate of _ _[*name*]_ _, **Deceased** [*or*] **Trust Created Under the Will of** _ _[*name*]_ _, **Deceased** [*or*] **Trust Created by Agreement dated** _ _[*date*]_ _, **by** _ _ [*name of settlor*]_ _	)	**No.** _ _ _ _ _ _ **EX PARTE PETITION FOR ORDER APPOINTING PRACTICE ADMINISTRATOR (PROBATE CODE** _ _[***§9764/§17200***]_ _, **BUSINESS & PROFESSIONS CODE §6185)** **Dep't:** _ _[*number*]_ _

[*Alternative 2: Appointment of practice administrator for disabled member]*

Conservatorship of _ _[*Conservatee's name*]_ _, **Conservatee** [*or*] **Trust Created by Agreement dated** _ _[*date*]_ _, **by** _ _[*name of settlor*]_ _	)	**No.** _ _ _ _ _ _ **EX PARTE PETITION FOR ORDER APPOINTING PRACTICE ADMINISTRATOR (PROBATE CODE** _ _[***§2468/§17200***]_ _, **BUSINESS & PROFESSIONS CODE §6185)** **Dep't:** _ _[*number*]_ _

[*Continue*]

[*Add one of the following alternatives*]

[*Alternative 1: Appointment of practice administrator for deceased member*]

Petitioner, _ _[*name*]_ _, _ _[*administrator/executor of the Estate of* _ _[*decedent's name*]_ _/*trustee of the* _ _[*name of trust*]_ _]_ _, **hereafter referred to as Decedent or Deceased Member), alleges:**

Decedent died _ _[*testate/intestate*]_ _ on _ _[*date*]_ _, in _ _[*County*]_ _, and was a resident of _ _[*name of county*]_ _ County, California.

At the time of _ _[*his/her*]_ _ death, Decedent was an active member in good standing of the State Bar of California with a law practice in _ _[*name of county*]_ _ County.

[*Add one of the following alternatives to Alternative 1*]

[*Alternative 1A: Executor or administrator*]

Petitioner was appointed _ _[*administrator of Decedent's estate/executor of Decedent's will*]_ _ by order of this court dated _ _[*date*]_ _. The order appointing Petitioner as _ _[*administrator/executor*]_ _ specifically granted Petitioner the power to file a petition with the court requesting the appointment of a practice administrator for Decedent's law practice.

[*Alternative 1B: Trustee*]

Petitioner is the presently acting Trustee of the _ _[*name of trust*]_ _. A true and correct copy of the _ _[*name of trust*]_ _ is attached to this petition and incorporated by this reference.

[*Continue*]

[*Alternative 2: Appointment of practice administrator for disabled member*]

Petitioner, _ _[*name*]_ _, _ _[*conservator of the estate of _ _[conservatee's name*]_ _/trustee of the _ _[*name of trust*]_ _]_ _, alleges:

There is probable cause to believe that _ _[*name of disabled member*]_ _ (hereafter referred to as Disabled Member) is incapable of engaging in the practice of law. _ _[*Set forth facts showing probable cause under Business and Professions Code §6190.*]_ _

At the time _ _[*name of disabled member*]_ _ became incapable of engaging in the practice of law, _ _[*he/she*]_ _ was an active member in good standing of the State Bar of California with a law practice in _ _[*name of county*]_ _ County.

[*Add one of the following alternatives to Alternative 2*]

[*Alternative 2A: Conservator*]

Petitioner was appointed conservator of _ _[*name of disabled member*]_ _'s Estate by order of this court dated _ _[*date*]_ _.

[*Alternative 2B: Trustee*]

Petitioner is the presently acting Trustee of the _ _[*name of trust*]_ _. A true and correct copy of the _ _[*name of trust*]_ _ is attached to this petition and incorporated by this reference.

[*Continue*]

The immediate appointment of a Practice Administrator is required to safeguard the interests of _ _[*Decedent's/the Disabled Member's*]_ _ estate.

Petitioner requests that the court appoint _ _[*name*]_ _, an active member in good standing of the State Bar of California, whose address is _ _[a*ddress*]_ _, as Practice Administrator.

Petitioner further requests that the court grant the Practice Administrator the power to take _ _[*specify which action(s)/all of the actions as enumerated in Business and Professions Code §6185*]_ _ in connection with the _ _[*Deceased/Disabled*]_ _ Member's law practice.

Petitioner is informed and believes and on that basis alleges the value of assets that will come under the Practice Administrator's control, including, but not limited to, funds in all accounts used by the _ _[*Deceased/Disabled*]_ _ Member, is _ _[*dollar amount*]_ _, and bond should be ordered in that amount.

WHEREFORE, Petitioner prays for an order of this Court that:

1. _ _[*Name*]_ _ be appointed as Practice Administrator.

2. _ _[*Name*]_ _, as Practice Administrator, be granted the power to do the following:

[*List all powers requested; see §11.7*]

A. Take control of all operating and client trust accounts, business assets, equipment, client directories, and premises that were used in the conduct of the _ _[*Deceased/Disabled*]_ _ Member's practice.

B. Take control and review all client files of the _ _[*Deceased/Disabled*]_ _ Member.

C. Contact each client of the _ _[*Deceased/Disabled*]_ _ Member who can be reasonably ascertained and located to inform the client of the death of the _ _[*Deceased/Disabled*]_ _ Member and of the appointment of a Practice Administrator. The Practice Administrator may discuss various options for the selection of successor counsel with the client.

D. In each case that is pending before any court or administrative body, notify the appropriate court or administrative body and contact opposing counsel in the cases under the control of the _ _[*Deceased/Disabled*]_ _ Member and obtain additional time for new counsel to appear for the affected client.

E. Determine the liabilities of the practice and pay them from the assets of the practice. If the assets of the practice are insufficient to pay these obligations or for the expenses incurred by the Practice Administrator to carry out the powers ordered under Business and Professions Code §6185, the Practice Administrator must apply to the personal representative to obtain the additional funds that may be required. If the personal representative and the Practice Administrator are unable to agree on the amount that is necessary for the Practice Administrator to undertake the duties ordered under this paragraph, either party may apply to the court having jurisdiction over the estate of the _ _[*Deceased/Disabled*]_ _ Member for an order requesting funds from the estate.

F. Employ any person, including but not limited to the employees of the _ _[*Deceased/Disabled*]_ _ Member, who may be necessary to assist the Practice Administrator in the management, winding up, and disposal of the practice.

G. Create a plan for disposition of the practice of the _ _[*Deceased/Disabled*]_ _ Member to protect its value as an asset of the estate of the _ _[*Deceased/Disabled*]_ _ Member, and, subject to the approval of the _ _[*personal representative/trustee/conservator*]_ _ of the estate, agree to the sale of the practice and its goodwill.

H. Subject to the approval of the personal representative of the estate, reach agreements with successor counsel for division of fees for work in process on the cases of the _ _[*Deceased/Disabled*]_ _ Member.

I. Subject to the prohibitions against soliciting cases, act as successor counsel for a client of the _ _[*Deceased/Disabled*]_ _ Member.

[*Continue*]

3. _ _[*Name*]_ _, as Practice Administrator, be ordered to post bond in the amount of _ _[*dollar amount*]_ _.

4. Notice of hearing on this petition be dispensed with.

5. For all other orders that the Court considers proper.

Date: _ _ _ _ _ _

__[*Signature*]__
_ _[*Typed name*]_ _
Petitioner

__[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Petitioner

VERIFICATION

I, _ _[*name*]_ _, declare:

I am the petitioner in the foregoing EX PARTE PETITION FOR ORDER APPOINTING PRACTICE ADMINISTRATOR. I have read the petition and know its contents. It is true of my own knowledge, except as to those matters that are stated in it on my information and belief, and as to those matters, I believe them to be true.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _,
Petitioner

Comment: This petition has been drafted as an ex parte petition. If the petitioner does not have a waiver of notice from the personal representative of the estate or if the personal representative has not petitioned or joined in the petition, the court will require a noticed hearing under Prob C §1220. Further allegations will be needed to demonstrate urgency so the practice administrator may be appointed at the earliest possible date.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/§11.9 2. Form: Order Appointing Practice Administrator

§11.9 2. Form: Order Appointing Practice Administrator

▶ To download **Word** version, right click and choose *Save Target As*

▶ To download **WordPerfect** version, right click and choose *Save Target As*

11.9-1 Order appointing practice administrator

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
Attorney for petitioner, _ _[*name*]_ _

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF _ _ _ _ _ _

[*Use one of the following alternatives*]

[*Alternative 1: Order appointing practice administrator for deceased member]*

Estate of _ _[*decedent's name*]_ _, **Deceased** [*or*] **Trust Created Under the Will of** _ _[*name*]_ _, **Deceased** [*or*] **Trust Created by Agreement dated** _ _[*date*]_ _, **by** _ _[*name of settlor*]_	)	**No. _ _ _ _ _ _** **EX PARTE ORDER APPOINTING PRACTICE ADMINISTRATOR (PROBATE CODE _ _[*§9764/§17200*]_ _, BUSINESS & PROFESSIONS CODE §6185)** **Dep't:** _ _[*number*]_ _

[*Alternative 2: Order appointing practice administrator for disabled member]*

Conservatorship of _ _[*Conservatee's name*]_ _, **Conservatee** [*or*] **Trust Created by Agreement dated** _ _[*date*]_ _, **by** _ _[*name of settlor*]_ _	)	**No. _ _ _ _ _ _** **EX PARTE ORDER APPOINTING PRACTICE ADMINISTRATOR (PROBATE CODE _ _[*§2468/§17200*]_ _, BUSINESS & PROFESSIONS CODE §6185)** **Dep't:** _ _[*number*]_ _

The Court, having examined the Ex Parte Petition for Order Appointing Practice Administrator, finds that the relief requested therein is proper.

WHEREFORE, IT IS ORDERED:

1. _ _[*Name*]_ _ **is appointed as Practice Administrator for the practice of** _ _[*name of member*]_ _**.**

2. _ _[*Name*]_ _**, as Practice Administrator, is granted the power to do the following in regard to the** _ _[*Deceased/Disabled*]_ _ **Member's practice:**

[*List all powers granted; see §11.7*]

A. Take control of all operating and client trust accounts, business assets, equipment, client directories, and premises that were used in the conduct of the _ _[*Deceased/Disabled*]_ _ Member's practice.

B. Take control and review all client files of the _ _[*Deceased/Disabled*]_ _ Member.

C. Contact each client of the _ _[*Deceased/Disabled*]_ _ Member who can be reasonably ascertained and located to inform the client of the condition of the Member and of the appointment of a Practice Administrator; the Practice Administrator may discuss various options for the selection of successor counsel with the client.

D. In each case that is pending before any court or administrative body, notify the appropriate court or administrative body and contact opposing counsel in the cases under the control of the _ _[*Deceased/Disabled*]_ _ Member and obtain additional time for new counsel to appear for the affected client.

E. Determine the liabilities of the practice and pay them from the assets of the practice. If the assets of the practice are insufficient to pay these obligations or for the expenses incurred by the Practice Administrator to carry out the powers ordered under this section, the Practice Administrator must apply to the personal representative to obtain the additional funds that may be required. If the personal representative and the Practice Administrator are unable to agree on the amount that is necessary for the Practice Administrator to undertake the duties ordered under this paragraph, either party may apply to the court having jurisdiction over the estate of the _ _[*Deceased/Disabled*]_ _ Member for an order requesting funds from the estate.

F. Employ any person, including but not limited to the employees of the _ _[*Deceased/Disabled*]_ _ Member, who may be necessary to assist the Practice Administrator in the management, winding up, and disposal of the practice.

G. Create a plan for disposition of the practice of the _ _[*Deceased/Disabled*]_ _ Member to protect its value as an asset of the estate of the _ _[*Deceased/Disabled*]_ _ Member, and, subject to the approval of the personal representative of the estate, agree to the sale of the practice and its goodwill.

H. Subject to the approval of the personal representative of the estate, reach agreements with successor counsel for division of fees for work in process on the cases of the _ _[*Deceased/Disabled*]_ _ Member.

I. Subject to the prohibitions against soliciting cases, act as successor counsel for a client of the _ _[*Deceased/Disabled*]_ _ Member.

[*Continue*]

3. _ _[*Name*]_ _, as Practice Administrator, shall post bond in the amount of _ _[*dollar amount*]_ _.

4. Notice of hearing on the petition is dispensed with.

Date: _ _ _ _ _ _ __[*Signature*]__
Judge of the Superior Court

© The Regents of the University of California

III. PRACTICE ADMINISTRATOR: PRACTICAL CONSIDERATIONS

§11.10 A. Nomination of Practice Administrator

Probate Code §§2468 and 9764 provide for priority of a person nominated by the deceased or disabled member to act as practice administrator. This allows the member to choose the person to take control of his or her practice in the event of death or disability. In making a nomination, the member should consider the following:

- Is the nominee an attorney experienced in the field of law in which the member practices?
- What conflicts of interest may arise if the practice administrator takes control of the member's practice? If a substantial number of conflicts exist, the nominee's appointment may be denied by the court.
- Does the nominee have the time and financial ability to take control of the member's practice in case of an emergency?
- Will the nominee likely be successful in dealing with the member's clients?

These questions may be difficult to answer in advance of an emergency. Any nomination should be reviewed periodically to ensure that the nominee is the right person to act as practice administrator.

To maximize the effectiveness of the person nominated to act as practice administrator, the member's practice and files need to be in a reasonable state of organization. Client lists need to be maintained, files kept in order, closed files segregated from active files, calendars properly marked, and original documents inventoried with updated addresses of the owners. Additionally, billing records, business account statements, and trust accounts must be current in order for the practice administrator to have any real chance of deriving value from the practice. Before a nominee accepts the post of practice administrator, the level of organization of the member's practice should be carefully evaluated.

© The Regents of the University of California

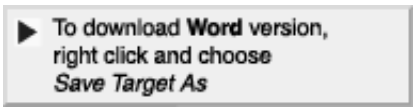
§11.11 1. Agreements to Take Control of a Practice

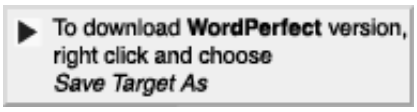
Before the enactment of Prob C §§2468 and 9764, the question of agreements between practitioners to take over each other's practice in case of emergency had been discussed by the Trust and Estates Section of the State Bar. Sometimes referred to as buddy agreements, counsel would agree to act in each other's place in case of an emergency or death. However, problems of maintaining confidentiality of client files and the informal nature of such agreements often hampered their effectiveness. With the enactment of the practice administrator statutes, a more effective method is available to take control of a practice along with the safeguards available only with court action and instruction. Accordingly, any such agreement should take the form of a nomination to act as practice administrator rather than some informal agreement designed to act outside of the context of a court proceeding.

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/11 Planning for Disposition of a Law Practice/§11.12 2. Form: Nomination of Practice Administrator

§11.12 2. Form: Nomination of Practice Administrator





11.12-1 Nomination of practice administrator

I, _ _[*name*]_ _ (hereafter referred to as Attorney), hereby nominate _ _[*name*]_ _ (hereafter referred to as Nominee), to act as my Practice Administrator if I should be a solo practitioner at the time of my death or disability.

In order to induce Nominee to act as Practice Administrator, Attorney promises to do the following:

1. Maintain Attorney's files in proper order with a current list of clients so that Nominee will be able to ascertain and contact Attorney's clients.

2. Maintain Attorney's financial records so that Nominee will be able to determine Attorney's financial condition, status of any lease or ownership of the premises, and the status of any and all employees, including but not limited to job descriptions, salaries, and benefits.

3. Maintain Attorney's closed files that have not been returned to clients in proper order and condition.

4. Maintain Attorney's calendar of upcoming actions and appointments so that Nominee will be able to inform the clients of any deadlines and to take any action necessary to protect the clients. Such a calendar will include any and all court dates, discovery deadlines, response deadlines, and appointments or other events that may affect a client matter.

Nominee is free to become successor counsel to any of Attorney's clients with any allocation of fees to be determined after negotiation with Attorney's estate.

Attorney shall inform all persons who require knowledge of Nominee's nomination to act as practice administrator. Such persons shall include Attorney's executor, potential conservator, trustee, and any clients who may reasonably be affected by this nomination.

Nominee promises to give prompt consideration to the question of accepting the post of practice administrator. In receiving such a promise, Attorney acknowledges that Nominee is not required to accept such a position and may decline nomination without liability to Attorney, _ _[*his/her*]_ _ estate, or any person interested in _ _[*his/her*]_ _ practice. However, if Nominee accepts the position of practice administrator and is so appointed, _ _[*he/she*]_ _ promises to act to the best of _ _[*his/her*]_ _ ability to protect the clients of Attorney and to protect the value of the practice to the extent that circumstances existing at and after the time of appointment will allow.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Attorney

I, _ _[*name*]_ _, Nominee to act as Practice Administrator, hereby promise to give prompt consideration to the acceptance of this nomination at such time that the undersigned is informed of an emergency that would lead to my appointment hereunder.

Date: _ _ _ _ _ _ __[*Signature*]__
_ _[*Typed name*]_ _
Nominee

Comment: The agreement is designed to remind the attorney of what must be done in order to allow any person to

act as a practice administrator. The absence of these conditions leads to enormous difficulty for anyone attempting to administer a practice or to derive value for the estate. This agreement is merely designed to obtain the nominee's promise to act promptly on any decision to accept the nomination. This is not to imply that greater obligations could not be imposed in return for consideration if the parties so decided. However, in most cases, some years may pass between the execution of such an agreement and its activation. Counsel should be careful to avoid an obligation if the condition of the practice at the time of an emergency cannot be fully anticipated. Any greater involvement may require merging existing practices so that counsel will be able to exert some control and be kept informed of developments.

© The Regents of the University of California

§11.13 B. Acting as Practice Administrator

The statute envisions both the need for the practice administrator to work cooperatively with the personal representative of the estate or the conservator and the potential tensions between the interests of the estate and the practice administrator. If a business with rented premises and employees existed at the time of death or disability, the practice administrator will need to make an immediate assessment of the cash needs of the business and whether application to the estate for funds will be required. If the personal representative or the conservator does not agree with the request for funds, the practice administrator and the fiduciary will need to seek a court ruling on the request.

Such an assessment will inevitably include the practice administrator's plan to manage and dispose of the practice and thereby preserve the value of the estate's interest. Much will depend on the existence of viable receivables and valuable work in process. Anticipated fees from the administration of trusts and estates, contingency fee cases, and other types of cases for which fees are not generated primarily on an hourly basis will largely determine the goodwill value of the practice, assuming that the clients are willing to follow the practice administrator's recommendations on successor counsel. The parties will need to keep in mind that the files belong to the client and not to the attorney's estate; the attorney has no ownership interest in them. See *Fracasse v Brent* (1972) 6 C3d 784, 100 CR 385 (client has power and right to discharge attorney at any time, with or without cause); Cal Rules of Prof Cond 3-700(D) (after discharge, at client's request, attorney must release all client papers and property to client).

Additionally, the practice administrator and the personal representative (or conservator) will need to reach agreements on fee arrangements with successor counsel and on the sale of the practice. See §11.15. If the parties are unable to agree, either party may seek an order of the court or request instructions in accordance with Bus & P C §6185(b).

On completion of the practice administrator's services, he or she must prepare an accounting and petition for court approval. When the account is settled, the surety on the practice administrator's bond may be exonerated and the practice administrator discharged. Prob C §§2468(h), 9764(h), 17200(b)(22)-(23). The practice administrator will not receive fees for his or her services unless a petition for fees is brought and approved by the court. The fees are paid from the proceeds of the law practice first and then from the estate only if the assets of the practice are insufficient to pay them. Prob C §§2468(g), 9764(g), 17200(b)(22)-(23).

NOTE: Probate Code §§9764 regarding deceased members and 2468 regarding disabled members are substantially identical except in one important respect. If a disabled member recovers sufficiently from his or her disability to resume practice, the disabled member may seek to terminate the role of the practice administrator and be restored to control of the practice.

© The Regents of the University of California

§11.14 1. Considerations in Disposing of Law Practice

In many instances, little value will exist in a law practice by the time a practice administrator is required; the attorney may already have substantially curtailed his or her practice and essentially retired. One of the difficulties that a practice administrator will face will be the disposition of files. Very often, files have been held for many years, and the clients have themselves died or moved away and cannot be found easily. The problem may be compounded if the deceased or disabled member had the practice of maintaining original client documents such as wills, trusts, deeds, and agreements.

The practice administrator's task will be made substantially easier if the deceased or disabled member undertook to keep track of his or her clients and to dispose of files that are no longer current and that the client does not wish to keep.

Any attorney agreeing to act as a practice administrator should review the files carefully to determine if any value exists in the practice and if the files are in sufficiently good order that clients can be located and the nature of their matter determined.

If the deceased or disabled member had an active practice, the practice administrator will need to decide on the following fairly quickly:

- Should the attorney's premises be maintained in order to store files and to have a place to meet with the clients and discuss the disposition of files?
- Should the attorney's staff continue to be employed by the practice? If cash flow is sufficient, retaining the secretary or other staff of the member will provide clients with a sense of continuity and also assist the practice administrator with matters that need attention.
- Should the practice administrator seek to become successor counsel? Assuming that the practice administrator is the nominee of the member, the parties may have contemplated that the practice administrator may become the successor counsel. This may in fact be the best means of preserving value for the estate because the practice administrator may already be familiar with the member's practice and clientele. The practice administrator may also have the best chance of becoming a successor counsel who will agree to make a reasonable allocation of fees between the estate and himself or herself.

© The Regents of the University of California

§11.15 2. Fee Allocation Problems

Aside from the financial and tangible assets of a law practice, the practice administrator needs to focus on the disposition of the cases previously handled by the deceased or disabled member. Clients must be notified of the counsel's inability to continue their representation and asked whether their file should be sent to new counsel or collected by the client, or if the client wishes to make arrangements with the practice administrator to become successor counsel.

If the matter is billed on an hourly basis, the time expended will become an account receivable collectible by the practice administrator. If a retainer is on deposit in the trust account of the deceased or disabled member, the receivable will need to be deducted from the deposit and the balance returned to the client or paid to new counsel as instructed. In the absence of a retainer, the practice administrator will need to bill the client and attempt to obtain payment.

Some matters are charged by agreement on a flat fee basis, such as estate planning documents, or are based on court order or statutory fees. Based on the work accomplished by the disabled or deceased member, an allocation of fees will be required on a case-by-case basis. In the case of statutory fees, the court in the probate proceeding will order an allocation of fees between the previous and successor counsel. In other matters that are not based on statutory percentages, a petition will be required to obtain a determination of fees payable to the deceased or disabled member. The same may also apply to family law matters in which the court will make orders allocating fees between the parties.

If the deceased or disabled member was counsel in a contingency matter, the estate will be entitled to an allocation of fees based on the reasonable value of services performed in case the contingency arises as a result of settlement or trial. See *Fracasse v Brent* (1972) 6 C3d 784, 100 CR 385. In *Cazeres v Saenz* (1989) 208 CA3d 279, 256 CR 209, the court measured the reasonable value of services rendered in partial performance of the contract prorated on the basis of the contingency fee rather than relying on the fee-splitting contract between the associated counsels or an hourly fee.

The practice administrator will need to make an analysis of each case to determine the amount that may be due, if any, and how it should be calculated or allocated between the estate and deceased member.

If the practice administrator becomes successor counsel, as expressly permitted by statute, arm's-length negotiation will be required between the personal representative (or conservator) and the practice administrator. See Bus & P C §6185. For this reason, the statute does not permit the practice administrator to be counsel for the personal representative or conservator. Prob C §§2468(e), 9764(e).

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/Table of Statutes, Regulations, and Rules

Table of Statutes, Regulations, and Rules

CALIFORNIA

Constitution

Art II, §10(c): §§5.3-5.5

Art XIIIA: §3.12

Statutes

BUSINESS AND PROFESSIONS CODE

6000-6238: §11.1

6180: §11.2

6180-6180.14: §11.1

6180-6190.6: §11.1

6180.5: §11.2

6180.5(d): §11.2

6180.7: §11.2

6185: §§11.1, 11.6, 11.8-11.9, 11.15

6185(a): §11.7

6185(b): §11.13

6190: §11.8

6190-6190.1: §11.2

6190.1(b): §11.2

6190.4: §11.2

14202(h): §8.33C

14207: §8.33C

CIVIL CODE

51: §8.15C

685-686: §4.11

815.3: §§3.119, 4.24

986: §8.34

986(a)(7): §8.34

986(b)(1)-(2): §8.34

986(c)(2): §8.34

990 (former): §8.35

3344: §8.35

3344.1: §8.35

3344.1(a)(3): §8.35

3344.1(b): §8.35

3344.1(d): §8.35

3344.1(e): §8.35

3344.1(g): §8.35

3344.1(h): §8.35

CODE OF CIVIL PROCEDURE

699.720: §1.49

708.310: §1.49

872.210: §4.13

872.710: §4.13

CORPORATIONS CODE

1900(a): §1.29

15611-15723: §§1.6, 4.16

15611(r): §§1.6, 4.16

15621(a): §1.6

15632: §4.16

15632(a)-(b): §1.6

15636(f)(2): §1.32

15642: §1.7

15643: §§1.6, 4.16, 4.28

15681: §§1.7, 1.32

15681(b): §1.29

15724: §§1.7, 4.16

15900-15912.07: §§1.6, 1.32, 1.37C, 4.16

15901.02(q): §§1.6, 4.16

15902.01(a): §1.6

15903.01-15903.07: §1.32

15903.02-15903.03: §4.16

15903.03: §1.6

15904.02-15904.06: §4.16

15904.04: §1.6

15904.05: §1.6

15906.03: §1.7

15907.02: §1.49

15907.03: §1.49

15908.01(b): §1.29

15908.01(c): §1.7

15912.06: §§1.6, 4.16

16100-16962: §4.15

16101(1): §4.14

16101(9): §1.6

16201: §4.15

16202(a): §4.14

16301(1): §4.15

16306: §4.15

16401: §4.15

16404: §4.28

16801-16807: §4.39

16801(1): §4.15

17000-17655: §4.17

17050(a): §1.9

17050(b): §1.12

17101: §4.17

17101(a)-(b): §1.9

17101(b): §1.9

17150-17151: §1.9

17153: §4.28

17158(a): §1.9

17302: §1.49

17302(b): §1.49

17350(b): §1.29

25000-25707: §9.14

FAMILY CODE

760: §2.12

770: §2.12

1100: §§8.13, 8.29

1100(a): §8.13

5206: §8.29

PROBATE CODE

7 (former): §6.2

26: §3.29

100(a): §§10.42-10.43

100(b): §10.42

1220: §11.8

2468: §§11.1, 11.3, 11.8-11.11, 11.13

2468(a): §11.4

2468(b): §11.5

2468(c): §§11.6-11.7

2468(d): §11.6

2468(e): §11.15

2468(e)-(f): §11.6

2468(g): §11.13

2468(h): §11.13

5000(a): §10.42

6102: §6.2

6450-6455: §3.29

9764: §§11.1, 11.3, 11.8-11.11, 11.13

9764(a): §11.4

9764(b): §11.5

9764(c): §§11.6-11.7

9764(d): §11.6

9764(e): §11.15

9764(e)-(f): §11.6

9764(g): §11.13

9764(h): §11.13

15211: §6.2A

15212: §§6.2-6.2B, 6.3, 6.14

15212 (former): §6.2

15212(a): §§6.2-6.2A, 6.14

15212(b)(1): §6.2A

15212(b)(2): §§6.2A, 6.3, 6.27

15212(c): §6.2B

15212(d): §6.2B

15212(e): §§6.2B, 6.4A, 6.12, 6.24, 6.32

15212(f): §6.2B

15212(g)-(h): §6.2A

15212(i): §6.2

15408: §6.2A

15681: §6.24

16048: §§9.22, 9.51

16062: §§6.2B, 6.4A, 6.12, 6.34-6.35

17200: §§11.1, 11.8-11.9

17200-17211: §6.2B

17200(b)(22)-(23): §§11.1, 11.3-11.7, 11.13

20100(a): §5.25

20110(b)(1): §3.69

20114: §3.69

21114: §§6.2A, 6.27

21115: §3.29

21118: §3.72

21350-21351: §6.32

REVENUE AND TAXATION CODE

60: §4.35

62(a): §4.35

62(a)(2): §1.52

62(d): §4.35

62(e): §4.35

63: §4.35

63.1: §4.35

63.1(a)(1)-(2): §1.52

63.1(a)(3): §4.35

63.1(c)(2): §4.35

64(a): §4.35

64(c)-(d): §4.35

64(d): §1.52

65(b): §4.35

110.1: §4.35

402.1: §§3.119, 4.24

11911: §1.52

11925(d): §1.52

13302: §§5.5, 5.26

13304: §5.5

13411: §5.26

17024.5: §7.2

17062(b)(3)(A)(iii): §10.44

17062(b)(5)(B): §10.44

17062(b)(6)(B): §10.44

17062(b)(7): §10.44

17201: §7.2

17851-17857.5: §4.16

17851-17865: §4.15

17935-17936: §§4.16, 5.14

17935(a): §1.6

17941-17943: §§4.17, 5.14

17941(a): §1.9

17942: §§1.9, 5.14

19394: §5.14

23153: §§4.16, 5.14

23153(d)(1): §§1.6, 4.17, 5.14

23153(d)(2): §1.9

23800-23813: §1.10

ACTS BY POPULAR NAME

Astaire Celebrity Image Protection Act (ACIPA): §8.35

Beverly-Killea Limited Liability Company Act: §4.17

California Arbitration Act: §4.39

California Revised Limited Partnership Act (CRLPA): §§1.6, 4.16

Corporate Securities Law of 1968: §9.14

Limited Partnership Act of 2008 (Re-RULPA): §§1.6, 1.32, 1.37C, 4.16

Revised Uniform Partnership Act: §4.15

State Bar Act: §11.1

Uniform Partnership Act of 1994: §4.15

Uniform Prudent Investor Act: §9.51

Unruh Civil Rights Act: §8.15C

SESSION LAWS

Stats 1999, ch 998, 1000 §9.5: §8.35

Stats 1998, ch 682: §11.1

Stats 1984, ch 1704: §8.35

Regulations

CALIFORNIA CODE OF REGULATIONS

Title 2

1138.20: §5.5

Rules

CALIFORNIA RULES OF PROFESSIONAL CONDUCT

3-110: §1.4

3-110(C): §1.4

3-310: §3.1A

3-310(C): §1.4

3-700(D): §11.13

UNITED STATES

Constitution

Art I, §8

cl 3: §8.33B

cl 8: §§8.3, 8.25, 8.33B

Amend I: §8.35

Statutes

UNITED STATES CODE

Title 15

77a-77aa: §§9.2, 10.19

77d(1): §9.43

77d(1)-(2): §§9.5, 9.32

78a-78mm: §9.2

78ff: §9.4

78l: §9.12

78m: §9.6

78m(d): §§9.3, 9.12, 9.12B, 9.13, 9.24, 9.50

78o(d): §9.6

78p: §§9.3, 9.12

78p(a): §§9.12, 9.24, 9.50

78p(a)(1): §9.12

78p(a)(2)(C): §9.12

78p(b): §§9.12, 9.17, 9.24, 9.31, 9.50

78p(c): §§9.36, 9.38

78u-1: §9.4

1051: §8.33D

1051-1127: §8.33B

1051(a)-(b): §8.33D

1052: §8.33E

1058: §8.33D

1058(a): §8.33F

1059: §8.33D

1060(a): §8.33I

1111: §8.33D

1127: §§8.33D, 8.33F

Title 17

101: §§8.8, 8.15B-8.15C

102(a): §8.5

106(1): §8.6

106(2): §8.6

106(3): §8.6

106(4)-(6): §8.6

106A: §§8.4, 8.6

201(a): §8.7

201(b): §8.8

201(d)(1): §8.12

201(d)(2): §8.12

202: §8.19

203: §8.14

203(a): §§8.15B, 8.16-8.16A, 8.17

203(a)(1): §8.16A

203(a)(2): §8.16A

203(a)(2)(A): §8.16A

203(a)(2)(B)-(C): §8.16A

203(a)(2)(D): §8.16A

203(a)(3): §8.16B

203(a)(4): §8.17

204(a): §8.12

302(a): §8.11

302(b): §8.11

302(c): §8.11

304(a): §8.14

304(c): §§8.14, 8.15A, 8.16A, 8.17

304(c): §8.15B

304(c)-(d): §8.15

304(c)(1)-(2): §8.15C

304(c)(3): §8.15D

304(c)(4): §§8.15D, 8.17

304(c)(5): §8.15E

304(c)(6)(A): §8.17

304(d): §8.15D

501: §8.22

505: §8.22

Title 35: §8.25

41(b): §8.28

116: §8.26

117: §8.26

154: §§8.27-8.28

154 (former): §8.28

261: §8.29

262: §8.29

271(a): §8.27

INTERNAL REVENUE CODE

Subch K: §§1.6, 9.34

1(e): §6.29

1(g): §3.11

1(h): §9.15

1(h)-(i): §7.8

1(h)(1): §9.16

1(h)(1)(C): §3.6

1(h)(4): §9.16

1(h)(5): §§7.8-7.9

1(h)(5)(A): §7.9

1(h)(11): §3.6

1(h)(11)(B)(iii): §§9.38, 9.42, 9.46

22(e)(3): §10.24

55-59: §2.4

55(b)(1)(A)(i)(I): §10.44

55(b)(1)(A)(i)(II): §10.44

55(d)(1)(B): §10.44

55(d)(3): §10.44

56(b)(3): §10.6

57(a)(7): §9.16

61: §§3.75, 8.18

68(a): §9.25

83(a): §§9.17, 10.3, 10.18, 10.29

83(a)(3): §9.17

83(b): §§9.17-9.18, 9.20

83(b)(2): §9.17

83(c)(1): §9.17

83(c)(3): §9.17

83(h): §10.8

101(a)(2)(B): §1.54

121: §3.66

123(R): §10.24

151(c)(4): §3.60

152(c)(3)(A): §3.11

162: §3.75

163(d): §9.35

163(h): §9.35

165: §3.66

170: §§3.119-3.119A, 4.24-4.25, 7.2, 7.19, 7.30, 7.57

170(a)(1): §§7.19, 10.29

170(a)(3): §§7.26, 7.30-7.33

170(b): §9.25

170(b)(1): §4.24

170(b)(1)(A): §§7.5-7.6, 7.13, 7.16, 7.18

170(b)(1)(A)-(D): §3.119A

170(b)(1)(A)(i)-(viii): §§7.4, 7.62

170(b)(1)(A)(iv): §7.34

170(b)(1)(A)(vii): §7.36

170(b)(1)(B): §§7.4-7.6, 7.13, 7.18

170(b)(1)(C): §§3.119A, 7.18

170(b)(1)(C)(i): §§7.14, 7.18, 8.19

170(b)(1)(C)(ii): §7.14

170(b)(1)(C)(iii): §7.14

170(b)(1)(C)(iv): §7.9

170(b)(1)(D): §7.18

170(b)(1)(D)(i): §7.18

170(b)(1)(D)(ii): §§7.14, 7.18

170(b)(1)(E): §3.119A

170(b)(1)(E)(i): §3.119A

170(b)(1)(E)(iv): §3.119A

170(b)(1)(E)(v): §3.119A

170(b)(1)(F): §§7.5, 7.18

170(b)(1)(F)(i): §7.36

170(b)(1)(F)(i)-(iii): §7.4

170(b)(1)(G): §§3.119A, 7.13, 7.18

170(b)(2): §3.119A

170(c): §§7.1, 7.28B, 10.29

170(c)(1): §7.16

170(c)(2): §3.119

170(d)(1)(A): §§7.13-7.14, 7.18

170(e)(1): §§7.14, 7.61

170(e)(1)(A): §§7.10, 7.13, 7.18, 8.19, 8.31, 10.29

170(e)(1)(B)(i): §§7.16, 7.33-7.34, 7.42-7.43

170(e)(1)(B)(ii): §§7.14, 7.18, 9.25

170(e)(1)(B)(iii): §8.31

170(e)(1)(B)(iv): §7.12A

170(e)(5): §9.25

170(e)(7)(A): §7.16

170(e)(7)(B): §7.16

170(f): §7.27

170(f)(2)(A): §§7.31-7.32

170(f)(3)(A): §§7.26, 7.30, 8.19, 8.31

170(f)(3)(B)(i): §7.31

170(f)(3)(B)(ii): §§7.26, 8.19

170(f)(3)(B)(iii): §3.119

170(f)(11): §7.19

170(f)(11)(E)(i): §7.20

170(f)(11)(E)(ii)-(iii): §7.21

170(f)(15)(A): §7.12A

170(f)(15)(B): §7.12A

170(f)(16)(D)(ii): §7.19

170(h)(1): §§3.119-3.119A, 3.120, 4.24

170(h)(2): §§3.119, 4.24

170(h)(3): §§3.119, 4.24

170(h)(4): §§3.119, 4.24

170(h)(4)(A)(iii): §3.119

170(h)(5): §§3.119, 4.24

170(m): §8.31

170(m)(7): §8.31

170(o): §§7.26, 7.28-7.28A, 7.28G

170(o)(1)(A): §7.28E

170(o)(2): §7.28A

170(o)(3)(A): §7.28D

170(o)(3)(A)(i): §§7.28B, 7.28F

170(o)(3)(A)(ii): §7.28C

170(o)(3)(B): §7.28D

172: §§7.13, 7.18

246(c)(4): §§9.38, 9.42, 9.46

264(a)(1): §2.4

267(b): §7.21

267(c)(4): §§3.85, 3.87, 3.95

280A(d)(1): §4.21

301: §§2.41, 3.6

302: §3.6

303: §§2.4, 2.40-2.41, 3.1, 3.3, 3.5, 3.9, 3.14, 3.71, 3.95, 3.105-3.106, 3.108-3.109, 3.112-3.115, 3.117

303(a): §§2.41, 3.107, 3.110

303(a)(1): §3.116

303(b)(1)(A): §3.109

303(b)(1)(C): §3.117

303(b)(2): §3.106

303(b)(2)(A): §§2.41, 3.105

303(b)(2)(B): §§2.41, 3.106

303(b)(3): §3.108

303(b)(4): §§3.105, 3.109

303(d): §3.116

306: §3.112

311: §3.106

317: §3.111

336: §§1.11, 3.106

337: §3.106

351: §3.118

351(a): §1.13

351(e): §§1.13, 9.34

355: §3.95

357(c): §1.13

368(a)(1): §3.95

368(a)(2)(F): §9.34

409A: §10.8

409A(a)(1)(B)(i)(II): §10.8

421(a): §10.5

421(b): §§10.5, 10.7

421(c)(1)(A): §10.40

422: §10.4

422(a)(1): §§10.4-10.5, 10.40

422(a)(2): §§10.4, 10.36, 10.40

422(b): §10.3

422(b)(1): §10.4

422(b)(2): §10.4

422(b)(3): §10.4

422(b)(4): §10.4

422(b)(5): §10.4

422(c)(5): §10.4

422(c)(6): §10.4

422(d): §10.4

423: §10.43

424(h)(1): §10.25

453: §9.32

453(k)(2): §9.32

501: §§7.16, 7.43, 7.62

501(c): §7.18

501(c)(3): §§3.119, 4.24, 7.4, 7.7, 7.28C, 7.38-7.39, 7.43

508(a): §7.42

508(d)(2): §7.42

508(e): §7.42

509: §7.43

509(a): §§7.4, 7.7, 7.18

509(a)(2): §7.5

509(a)(3): §§3.119, 7.5, 7.18

531: §2.4

533: §2.4

537(a)(2): §2.4

537(b)(1): §2.4

641: §6.29

641(c): §2.36

642(c)(1): §9.25

642(c)(5): §7.31

642(h): §9.51

651: §6.29

661: §6.29

663(c): §2.33

664: §7.31

664(b): §7.32

664(c): §7.32

664(d)(1): §7.31

664(d)(1)-(2): §6.30

664(d)(1)(D): §7.32

664(d)(2)-(3): §7.31

664(d)(2)(D): §§7.32, 9.25

664(d)(3)(A): §7.35A

664(d)(3)(B): §7.35A

671-677: §9.32

671-679: §§2.26, 2.31-2.32

672(c): §7.35

673: §2.21

675(2): §9.31

675(4)(C): §§9.31, 9.31D

677(a): §2.21

678(a): §2.35

691: §§3.70, 3.74, 9.58

691(a)(2): §3.76

691(c): §3.74

701-707: §4.16

701-777: §§1.6, 4.15

721(a): §1.13

721(b): §§1.13, 9.34

731(a): §1.13

743(b): §9.47

752(b): §1.13

754: §§1.18, 8.20

1014: §§1.18, 2.12, 2.41, 3.8, 3.11, 3.14, 3.65, 3.68, 3.74-3.75, 3.105, 4.22, 5.20, 7.9, 7.61A, 9.18, 9.42

1014(a): §3.14

1014(a)(3): §3.63

1014(b): §§3.26, 3.65

1014(c): §§3.74, 9.18

1015: §§1.18, 3.14, 7.12, 8.19

1016(c)(1): §3.67

1016(c)(2)(B): §3.67

1016(c)(5)(B): §3.67

1022(c): §5.20

1031: §§3.60, 5.12

1033: §3.60

1036: §3.113

1040: §§3.65, 3.72

1040(a): §3.64

1040(c): §3.64

1041: §10.33

1042: §9.16

1045: §9.16

1201: §3.66

1202(a): §9.16

1202(a)(3): §9.16

1202(c): §9.16

1202(f): §9.16

1202(g): §9.16

1202(h): §9.16

1221: §§3.66, 3.77, 7.9, 8.18, 8.35

1221(a)(3): §§7.11-7.12, 8.18-8.19

1221(a)(3)(C): §§7.9-7.10

1221(b)(3): §§7.13, 7.18, 8.18

1222(3): §7.9

1223(9): §§3.65, 3.77, 7.9

1223(10): §§3.65, 9.51

1231: §§3.77-3.78

1231(b)(3): §3.77

1231(b)(4): §3.77

1234(a)(2): §9.51

1235: §8.31

1235(a): §8.30

1235(a)(1)-(2): §8.30

1235(d): §8.30

1245: §3.12

1259: §§9.36, 9.40, 9.46

1259(c)(1)(A): §9.36

1259(c)(3)(A): §9.36

1361: §1.10

1361-1379: §1.10

1361(b)(1)(D): §2.13

1361(b)(1)(a): §2.32

1361(c)(2)(A): §2.31

1361(c)(2)(A)(i): §2.32

1361(c)(2)(A)(ii): §2.32

1361(c)(2)(A)(v): §2.36

1361(c)(2)(B)(i): §2.32

1361(c)(4): §2.13

1361(d)(1)(A): §2.33

1361(d)(1)(B): §2.35

1361(d)(2): §2.33

1361(d)(3): §2.33

1361(d)(3)(A): §2.33

1361(d)(3)(B): §2.34

1361(e)(1)(A): §2.36

1361(e)(1)(B): §2.36

1361(e)(2): §2.36

1361(e)(3): §2.37

1362(a)(2): §2.36

1362(f)(1)(A): §2.36

1363(a): §2.4

1368(c): §3.6

1368(e)(1)(B): §3.111

1402(a): §§3.41, 3.43

1402(a)(1): §§3.42-3.43

2001: §§1.14, 3.100, 10.10

2001(c)(1): §10.11

2001(c)(2)(B): §§5.9, 10.11, 10.16

2010: §§2.42, 5.3, 5.26, 10.10

2010(c): §§3.71, 3.81, 5.9, 10.16

2011: §§5.2-5.4, 5.10, 5.13, 5.24

2011 (former): §5.9

2011(f) (former): §5.16

2013: §§3.10, 5.24

2013(c): §5.24

2013(c)(1)(A): §5.24

2031: §§1.14, 2.4, 3.18, 3.68, 3.119, 7.60

2031-2046: §3.114

2031(a): §§4.31, 9.42

2031(c): §§3.120, 4.25, 5.11

2031(c)(1)-(3): §3.120

2031(c)(1)(A): §4.25

2031(c)(2): §4.25

2031(c)(3): §4.25

2031(c)(4): §4.25

2031(c)(5): §§3.120, 4.25

2031(c)(6): §4.25

2031(c)(8)(A): §3.120

2031(c)(8)(A)(ii): §4.25

2031(c)(8)(A)(iii): §4.25

2031(c)(8)(B): §§3.120, 4.25

2031(c)(9): §4.25

2031(c)(10): §§3.120, 4.25

2032: §§3.63, 3.74

2032(b): §7.42

2032A: §§3.1-3.1A, 3.3-3.7, 3.9, 3.14, 3.17-3.19, 3.22, 3.25, 3.27-3.34, 3.36, 3.39, 3.41, 3.43, 3.50-3.53, 3.55, 3.57, 3.59-3.60, 3.63-3.64, 3.66, 3.68-3.73, 3.80, 3.84, 3.101, 3.117, 3.119

2032A(a)(1): §§3.19-3.20

2032A(a)(1)(A): §3.20

2032A(a)(1)(B): §§3.50, 3.55

2032A(b)(1): §§3.20, 3.26-3.28, 3.66

2032A(b)(1)(A): §§3.20, 3.26

2032A(b)(1)(A)-(B): §3.30

2032A(b)(1)(B): §§3.20, 3.26, 3.52

2032A(b)(1)(C): §3.20

2032A(b)(1)(C)(ii): §3.39

2032A(b)(2): §3.22

2032A(b)(3)(A): §3.51

2032A(b)(3)(A)-(B): §3.31

2032A(b)(3)(B): §3.51

2032A(b)(4): §3.38

2032A(b)(5): §3.40

2032A(b)(5)(C): §§3.38, 3.60

2032A(c): §§3.2, 3.29, 3.54-3.56, 3.71, 3.117

2032A(c)(1): §3.56

2032A(c)(1)(A): §§3.58-3.59

2032A(c)(1)(B): §3.58

2032A(c)(2): §§3.57, 3.62

2032A(c)(2)(A)(ii): §3.57

2032A(c)(2)(E): §3.60

2032A(c)(4): §3.57

2032A(c)(5): §3.61

2032A(c)(6): §§3.55, 3.60

2032A(c)(6)(B): §3.60

2032A(c)(7)(A): §§3.25, 3.56, 3.59

2032A(c)(7)(B): §3.60

2032A(c)(7)(C): §3.60

2032A(c)(7)(E): §§3.25, 3.59

2032A(c)(8): §§3.59, 3.119

2032A(d): §§3.5, 3.50

2032A(d)(2): §§3.20, 3.27, 3.55, 3.61

2032A(d)(3): §3.50

2032A(e)(1): §§3.21, 3.27, 3.55

2032A(e)(1)-(2): §3.21

2032A(e)(2): §§3.28-3.29, 3.35, 3.117

2032A(e)(3): §3.23

2032A(e)(4): §3.23

2032A(e)(5): §§3.23, 3.119A

2032A(e)(6): §3.51

2032A(e)(7): §§3.19, 3.22, 3.34-3.37

2032A(e)(7)(A): §3.35

2032A(e)(7)(B): §3.35

2032A(e)(7)(B)(ii): §3.35

2032A(e)(7)(C): §3.37

2032A(e)(8): §§3.19, 3.22, 3.34-3.35, 3.37

2032A(e)(9): §3.26

2032A(e)(10): §3.31

2032A(e)(13): §§3.23, 3.60

2032A(e)(14): §3.60

2032A(h): §3.60

2032A(i): §3.60

2033: §§7.27, 7.59, 10.41

2035: §§1.37E, 3.33, 3.52, 3.117

2035(c)(1): §3.33

2035(c)(1)(A): §3.115

2035(c)(1)(B): §3.33

2035(c)(2): §3.102

2035(c)(3): §3.33

2036: §§1.13, 1.37B-1.37C, 3.12, 3.14, 4.22

2036(a): §§1.3, 1.14, 1.22, 1.30, 1.32, 1.34, 1.37, 1.37B, 1.37E, 1.41, 2.30, 4.34, 9.30-9.31

2036(a)(1): §§1.30, 1.37A, 4.27

2036(a)(1)-(2): §4.34

2036(a)(2): §§1.30, 1.37A-1.37C, 1.37E, 4.28

2036(b): §§1.22, 2.20, 2.30, 9.30-9.31, 9.31D

2036(b)(2): §§1.22, 2.20

2036(b)(3): §9.31D

2037: §9.30

2038: §4.29

2044: §§3.10, 3.68, 3.70, 3.103

2051: §10.16

2053: §§3.105, 3.107, 3.109, 3.117, 5.13

2053-2058: §10.16

2053(a): §9.42

2053(a)(2): §9.51

2053(a)(3): §7.59

2053(a)(4): §3.31

2054: §3.105

2055: §§3.119, 7.2, 7.7, 7.60

2055(a): §§6.28, 7.42, 7.66

2055(c): §7.42

2055(d): §7.42

2055(e): §§7.42-7.43

2055(e)(1): §7.42

2055(e)(2): §8.20

2055(e)(2)(A): §6.30

2055(e)(4): §§7.43, 8.20

2055(e)(4)(A): §7.43

2055(e)(4)(B): §7.43

2055(e)(4)(C): §§7.42-7.43, 8.20

2055(e)(4)(D): §7.43

2055(f): §§3.119, 4.25

2055(g) (former): §7.28F

2055(g)(1) (former): §7.28F

2056: §§10.10, 10.16

2056(b)(1): §8.32

2056(b)(1)(A): §§8.21, 8.32

2056(b)(1)(B): §8.32

2056(b)(7): §5.20

2056A(b)(10): §3.103

2057: §5.11

2058: §§5.2, 5.9, 5.11

2058(b)(2)(B): §5.24

2204: §3.99

2210(a): §§10.11, 10.16

2501: §1.14

2501(a): §§10.10, 10.12

2502: §10.10

2503: §10.10

2503(b): §§1.3, 2.28, 3.11, 4.30, 10.10

2503(b)(1): §§4.30, 10.10

2503(e): §§2.16, 10.10

2503(g): §10.10

2505: §§2.16, 10.10

2511: §10.12

2512: §1.14

2512(a): §4.31

2512(b): §§10.10, 10.12

2513: §10.10

2513(a): §10.10

2518: §§3.1A, 3.27, 5.22

2522: §§7.2, 7.7

2522(c): §7.43

2522(c)(2): §7.30

2522(e): §7.28F

2601: §3.100

2612(c): §3.100

2624(a): §3.68

2624(b): §3.68

2624(b)-(c): §3.68

2631: §2.28

2642: §2.22

2642(b)(2)(A): §3.68

2642(c): §2.28

2642(f): §4.22

2701: §§1.23-1.24, 2.13, 9.34

2701-2704: §§1.22, 3.4

2701(a)(1)-(2): §1.23

2701(b)(2): §§1.27-1.28

2701(e)(2): §2.7

2702: §§1.24, 2.18, 4.20

2702(a)-(b): §1.24

2702(a)(2): §2.18

2702(a)(3)(A)(ii): §4.20

2702(c)(2): §4.20

2702(e): §4.20

2703: §§1.25, 1.30, 1.34, 1.41, 2.4-2.5, 2.7-2.8, 3.15-3.16

2703(a): §2.5

2703(b): §§1.25, 1.34, 2.5

2703(b)(1): §2.6

2703(b)(2): §2.7

2703(b)(3): §2.8

2704: §§1.26, 2.13

2704(a): §§1.27-1.28

2704(b): §§1.28-1.30, 1.32, 1.50

2704(b)(3)(B): §1.28

2704(c)(1): §§1.27-1.28

2704(c)(2): §§1.27-1.28

3121-3128: §10.39

3121(a)(14): §10.41

3301-3309: §10.39

3306(a)(15): §10.41

4941: §§7.38, 9.26

4942(a)(1): §7.39

4942(e)(1): §7.39

4942(j): §7.18

4942(j)(3): §§7.5, 7.14, 7.36, 7.43

4942(j)(3)(A): §7.37

4942(j)(3)(B)(i): §7.38

4942(j)(3)(B)(ii): §7.40

4942(j)(3)(B)(iii): §7.41

4958: §9.26

6019: §10.10

6075(a): §3.91

6075(b)(1): §10.10

6165: §3.99

6166: §§2.40, 2.42, 3.1, 3.3, 3.5-3.6, 3.9-3.10, 3.14, 3.50, 3.66, 3.71, 3.73, 3.80-3.81, 3.83, 3.87, 3.89, 3.93, 3.99, 3.101-3.106, 3.117, 5.24, 8.23, 9.19

6166(G)(3)(A): §3.98

6166(G)(3)(B): §3.98

6166(a): §§2.42, 3.80, 3.83

6166(a)(1): §9.19

6166(a)(2): §3.89

6166(a)(3): §3.90

6166(b)(1): §§2.42, 3.47, 3.82

6166(b)(1)(B): §3.47

6166(b)(1)(B)(ii): §3.87

6166(b)(1)(C): §§3.47-3.48

6166(b)(1)(C)(i): §9.19

6166(b)(2): §3.47

6166(b)(2)(B): §3.85

6166(b)(2)(C): §3.85

6166(b)(2)(D): §§3.85, 3.87

6166(b)(3): §§3.66, 3.85

6166(b)(6): §3.89

6166(b)(7): §3.87

6166(b)(8): §3.88

6166(b)(8)-(9): §3.88

6166(b)(8)(A)(ii)-(iii): §3.88

6166(b)(9): §3.83

6166(c): §3.86

6166(d): §§3.50, 3.91

6166(f)(2): §3.90

6166(f)(3): §3.90

6166(f)(4): §3.90

6166(g): §§3.16, 3.83, 3.94, 3.101, 3.105

6166(g)(1(D): §3.94

6166(g)(1)(B): §§3.105, 3.117

6166(g)(1)(B)(i)-(ii): §3.95

6166(g)(1)(C)-(D): §3.95

6166(g)(1)(E): §3.96

6166(g)(2)(A): §3.97

6166(h)(1): §3.93

6166(h)(2)-(3): §3.93

6166(i): §3.100

6213: §3.109

6324: §3.80

6324(a): §§3.62, 3.99

6324A: §3.99

6324A(c): §3.99

6324A(d)(1): §3.99

6324A(d)(5): §3.99

6324B(a): §3.62

6324B(b): §3.62

6324B(c)(1): §3.62

6501: §§1.40, 3.109

6501(a): §1.40

6501(c)(9): §§1.40, 2.26

6601: §3.90

6601(a): §3.57

6601(j): §§2.42, 3.10, 3.81

6601(j)(1)(B): §§3.81, 3.87

6601(j)(2): §3.81

6621: §§2.42, 3.81, 3.87

6622: §3.81

6662(h)(2)(C): §1.39

6695A: §§1.39, 7.21

6701: §7.21

7517: §7.46

7520: §§1.24, 2.18, 2.24, 2.26, 7.32, 9.25, 9.44-9.45

7701(a): §1.6

7701(a)(1): §1.8

7701(a)(2): §1.13

7701(a)(9): §3.20

7872: §§2.26, 9.32

ACTS BY POPULAR NAME

Act to Promote the Progress of Useful Arts: §8.25

American Jobs Creation Act of 2004: §§8.19, 8.31

Berne Convention Implementation Act of 1988: §8.4

Copyright Act: §§8.3, 8.13, 8.25, 8.34

Copyright Act of 1909: §8.3, 8.16

Copyright Act of 1976: §§8.3, 8.10-8.11, 8.14, 8.15E, 8.16-8.17

Copyright Renewal Act of 1992: §8.10

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA-2001): §§3.19, 5.1-5.6, 5.10-5.11, 5.15-5.17, 5.26, 10.10-10.11, 10.16

§101(c)(11): §10.33

Economic Recovery Tax Act of 1981 (ERTA): §7.42

§423: §7.43

Lanham Act: §§8.33B, 8.33D

Licensing Act of 1662: §8.2

Patent Act: §8.25

Pension Protection Act of 2006: §§3.119A, 7.16, 7.19-7.21, 7.26, 7.28, 7.28F

Securities Act of 1933 (Securities Act): §§9.2, 10.19

§4(1): §§9.32, 9.43

§4(1)-(2): §9.5

§4(2): §9.32

Securities Exchange Act of 1934 (Exchange Act): §9.2

§12: §9.12

§13: §§9.6, 9.35

§13(d): §§9.3, 9.12, 9.12B, 9.13, 9.24, 9.26-9.27, 9.29, 9.31B, 9.31D, 9.32-9.35, 9.42, 9.46, 9.50, 9.60

§15(d): §9.6

§16: §§9.3, 9.12-9.13, 9.26, 9.31, 9.31D, 9.33, 9.35, 9.46

§16(a): §§9.12, 9.24, 9.26-9.27, 9.29, 9.31C-9.31D, 9.32-9.34, 9.38, 9.42, 9.50, 9.60

§16(b): §§9.12, 9.17, 9.24, 9.26, 9.29, 9.31, 9.31C-9.31D, 9.32-9.35, 9.38, 9.43, 9.46, 9.50, 9.60

§16(c): §9.38

§21A: §9.4

§32: §9.4

Sonny Bono Copyright Term Extension Act of 1998: §§8.3, 8.9-8.11, 8.14-8.15

Tax Technical Corrections Act of 2007: §7.28F

Taxpayer Relief Act of 1997: §7.25

Trademark Act of 1946 (Lanham Act): §§8.33B, 8.33D

Uruguay Round Agreements Act of 1994: §§8.4, 8.28

Visual Artists Rights Act of 1990 (VARA): §8.4

SESSION LAWS

Pub L 110-172, 121 Stat 1031: §7.28F

§3(j): §7.28F

Pub L 109-280, 120 Stat 780: §§3.119A, 7.16, 7.19-7.21, 7.26, 7.28, 7.28F

§1218(d): §7.28F

§1219(e)(2): §§7.20-7.21

Pub L 109-222, 120 Stat 346: §8.18

Pub L 108-357, 118 Stat 1418: §§8.19, 8.31

Pub L 107-16, 115 Stat 38: §§3.19, 5.1, 10.10, 10.33

Pub L 105-298, 112 Stat 2827: §8.3

Pub L 105-34, 111 Stat 788: §7.25

§1001(a): §9.40

Pub L 103-465, 108 Stat 4809: §§8.4, 8.28

Pub L 102-307, §102, 106 Stat 264: §8.10

Pub L 100-568, 102 Stat 2853: §8.4

Pub L 97-34, 95 Stat 172: §7.42

Pub L 94-553, 90 Stat 2541: §8.3

§302(a): §8.11

§304: §8.10

Ch 950, §1, 66 Stat 792: §8.25

Ch 592, 33 Stat 728 (Feb. 20, 1905): §8.33B

Ch 540, 60 Stat 427: §8.33B

Ch 320, 35 Stat 1075 (Mar. 4, 1909): §8.3

Ch 230, 16 Stat 198 (July 8, 1870): §8.33B

Ch 138, 21 Stat 502 (Mar. 3, 1881): §8.33B

Ch 15, 1 Stat 124 (May 31, 1790): §8.3

Ch 7, 1 Stat 109 (Apr. 10, 1790): §8.25

CONGRESSIONAL REPORTS

S Rep No. 3209, 101st Congress, 2d Sess (1990): §2.8

H Rep No. 94-1380: §§3.18, 3.36

H Rep No. 91-413: §7.35

H Rep No. 2222: §8.3

H Rep No. 148: §9.40

Regulations

CODE OF FEDERAL REGULATIONS

Title 7

240.16b-6: §9.17

Title 12

Pt 220 (Reg T): §9.35

Pt 221 (Reg U): §§9.35, 9.46

Title 17

230.144: §§9.3, 9.5, 9.12, 9.24, 10.31

230.144(a)(1): §9.5

230.144(a)(1)-(2): §9.32

230.144(a)(2): §§9.5, 9.50

230.144(a)(2)(i): §§9.8, 9.12, 9.29

230.144(a)(2)(ii): §§9.8, 9.27, 9.31A

230.144(a)(2)(ii)-(iii): §9.33

230.144(a)(2)(iii): §9.34

230.144(a)(3): §9.5

230.144(a)(b)(1)(i): §9.31D

230.144(b)(1): §§9.8-9.10

230.144(b)(1)(i): §9.29

230.144(c): §9.7

230.144(d): §§9.6, 9.33

230.144(d)(1): §§9.6, 9.31A, 9.43, 10.31

230.144(d)(2): §§9.32-9.33

230.144(d)(3): §9.6

230.144(d)(3)(i): §9.6

230.144(d)(3)(iv): §9.35

230.144(d)(3)(v): §§9.27, 9.29, 9.31A

230.144(d)(3)(v)-(vii): §9.6

230.144(d)(3)(vi): §9.32

230.144(e): §9.8

230.144(e)(1): §9.8

230.144(e)(2): §9.8

230.144(e)(3): §9.8

230.144(e)(3)(iii): §§9.25, 9.27, 9.29

230.144(e)(3)(iii)-(iv): §9.8

230.144(e)(3)(iv): §9.32

230.144(e)(3)(v): §9.8

230.144(e)(3)(vi): §9.50

230.144(f): §9.5

230.144(f)(1): §9.9

230.144(f)(2): §9.9

230.144(g)(3): §9.9

230.144(h): §§9.10, 9.26

230.144(h)(2): §§9.10, 9.29, 9.31A

230.144(i): §9.5

230.144(ii): §9.29

230.144(k): §9.31C

230.145: §§9.3, 9.11

230.145(c): §9.11

230.145(d): §9.11

230.145(e)(1): §9.11

230.701(c)(3): §§10.19, 10.31

240.10b-5: §§9.3-9.4, 9.24

240.10b5-1: §§9.4, 9.24

240.10b5-1(c)(1)(i): §9.4

240.13d-1: §§9.13, 9.26

240.13d-1(a): §9.34

240.13d-2(a): §§9.13, 9.29, 9.31D, 9.32-9.33

240.13d-3(a): §§9.12-9.13, 9.31B, 9.31D, 9.32-9.34

240.13d-3(a)-(b): §9.26

240.13d-3(d)(1): §§9.31, 9.31C-9.31D, 9.32

240.13d-3(d)(1)(i)(C): §9.13

240.13d-3(d)(3): §9.35

240.16a-1(a)(1): §§9.26, 9.31D, 9.32, 9.35

240.16a-1(a)(2): §§9.12, 9.26

240.16a-1(a)(2)(i): §§9.31, 9.31C-9.31D

240.16a-1(a)(2)(ii)(A): §§9.12, 9.29, 9.31, 9.31D, 9.32

240.16a-1(a)(2)(ii)(C): §9.12B

240.16a-1(a)(2)(ii)(E): §9.32

240.16a-1(a)(2)(iii): §§9.33-9.34

240.16a-1(e): §§9.12, 9.29

240.16a-2(d): §9.12A

240.16a-3(f): §9.12

240.16a-3(f)(1)(i): §9.26

240.16a-3(f)(1)(i)(A): §9.12

240.16a-3(g)(1): §§9.12, 9.38, 9.42, 9.46

240.16a-3(h): §9.12

240.16a-3(k): §9.12

240.16a-4(a): §9.38

240.16a-4(b)-(c): §9.42

240.16a-4(c): §9.38

240.16a-5(a): §9.31D

240.16a-8: §§9.12B, 9.32

240.16a-8(a): §9.12B

240.16a-8(a)(1): §9.31C

240.16a-8(a)(2)(i): §§9.26, 9.31D

240.16a-8(b): §§9.31, 9.31C

240.16a-8(b)(2): §§9.12B, 9.26

240.16a-8(b)(3): §9.26

240.16a-8(b)(3)-(4): §9.12B

240.16a-8(c): §§9.26, 9.31C

240.16a-8(d): §§9.12B, 9.26, 9.31

240.16a-13: §§9.31C, 9.33

240.16b-3(d)-(e): §9.12

240.16b-5: §§9.26, 9.29, 9.31C

240.16b-5(a): §9.33

240.16b-6(a): §§9.38, 9.42-9.43, 9.46

240.16b-6(b): §§9.38, 9.43, 9.46

240.16b-6(d): §9.43

240.16c-4: §§9.36, 9.38, 9.42

Pt 245: §9.3

Title 31

Pt 10 (Circular 230): §1.40A

10.35: §1.40A

Title 37

1.42-1.43: §8.26

1.45: §8.26

1.701-1.703: §8.28

1.710-1.791: §8.28

TREASURY REGULATIONS

1.83-1(b)(1): §10.18

1.83-1(d): §9.18

1.83-2: §9.20

1.83-2(a): §9.17

1.83-3(a)(2): §10.18

1.83-3(c): §9.20

1.83-3(j): §9.17

1.83-7(a): §§10.8, 10.18

1.83-7(b)(1)-(2): §10.18

1.170A-1(a): §7.44

1.170A-1(c): §7.44

1.170A-1(c)(1): §7.52

1.170A-1(c)(2): §7.45

1.170A-4(a)(1): §7.13

1.170A-4(b)(1)-(2): §7.10

1.170A-4(b)(2): §7.9

1.170A-4(b)(3): §7.16

1.170A-4(b)(3)(i): §§7.16, 7.34

1.170A-4(b)(3)(i)-(ii): §7.16

1.170A-5(a)(2): §§7.26, 8.19

1.170A-5(a)(4): §7.30

1.170A-5(a)(5): §7.30

1.170A-5(b), Example 7: §7.33

1.170A-5(b), Examples 1-2: §7.30

1.170A-6(c)(3)(iii): §7.31

1.170A-7: §7.30

1.170A-7(b)(1)(i): §§7.26, 8.19, 8.31

1.170A-8(d)(3): §§7.9-7.10

1.170A-9: §7.4

1.170A-9T: §7.4

1.170A-13: §7.44

1.170A-13(b)(2)(ii): §7.67

1.170A-13(b)(2)(ii)(G): §7.30

1.170A-13(c)(1): §7.19

1.170A-13(c)(1)(i): §7.19

1.170A-13(c)(2): §7.19

1.170A-13(c)(2)(i)(b): §7.21

1.170A-13(c)(3): §7.35

1.170A-13(c)(3)(i): §7.20

1.170A-13(c)(3)(i)-(ii): §7.20

1.170A-13(c)(3)(i)(A): §7.21

1.170A-13(c)(3)(iv)(A): §7.20

1.170A-13(c)(3)(iv)(B): §7.20

1.170A-13(c)(4): §7.22

1.170A-13(c)(4)(iv)(E): §7.22

1.170A-13(c)(4)(iv)(H): §7.22

1.170A-13(c)(5): §§7.21, 7.35

1.170A-13(c)(5)(i): §7.21

1.170A-13(c)(5)(ii): §7.21

1.170A-13(c)(5)(iv): §7.21

1.170A-13(c)(5)(iv)(B): §7.21

1.170A-13(c)(5)(iv)(F): §7.21

1.170A-13(c)(6)(i): §7.23

1.170A-14(b)(2): §§3.119, 4.24

1.170A-14(h)(3): §4.24

1.303-2(d): §§3.112-3.113

1.303-2(f): §3.114

1.351-1(c)(1): §1.13

1.351-1(c)(5): §1.13

1.351-1(c)(6): §1.13

1.409A-1(b)(5)(i)(A): §10.8

1.421-1(b)(2): §§10.40-10.41

1.421-1(h)(2): §10.4

1.421-2(c): §§10.40-10.41

1.421-2(c)(1): §10.40

1.421-2(d): §10.40

1.508-1(a)(3)(i)-(iii): §§7.7, 7.18

1.664-1(a)(3): §§7.31-7.32

1.664-1(a)(4): §7.35

1.664-1(a)(7): §7.35

1.664-3(a)(1): §7.31

1.664-3(a)(1)(c)-(d): §9.25

1.664-3(a)(1)(i)(c)(1): §7.35A

1.664-3(a)(1)(i)(c)(2): §7.35A

1.664-3(a)(1)(i)(c)(3): §7.35A

1.664-3(a)(1)(i)(d): §7.35A

1.664-3(a)(1)(i)(e): §7.35A

1.691(a)-1(b): §3.74

1.691(a)-2, Example 5: §§3.14, 3.74

1.691(a)-4: §3.76

1.752-2(b): §1.13

1.1014-1(a): §1.18

1.1014-3(a): §7.61A

1.1041-1T(b), Q&A-6: §10.37

1.1041-1T(b), Q&A-7: §10.37

1.1092(b)-2T(a): §9.46

1.1221-1(c)(1): §8.18

1.1231-2(a)(3): §3.78

1.1231-2(b)(2), Example 1: §3.78

1.1231-2(c)(1): §3.79

1.1235-1(b): §8.30

1.1235-2(b)-(c): §8.31

1.1361-1(h)(3)(i)(F): §2.36

1.1361-1(j)(6)(iii): §2.33

1.1361-1(j)(7)(i): §2.35

1.1361-1(j)(7)(ii): §2.35

1.1361-1(j)(11): §2.33

1.1361-1(j)(12): §2.33

1.1361-1(m)(2)(iii): §2.37

1.1361-1(m)(4): §2.36

1.1361-1(m)(4)(ii): §2.36

1.1361-1(m)(4)(iii): §2.36

1.1361-1(m)(5): §2.36

1.1361-1(m)(6): §2.37

1.1361-1(m)(7): §2.37

1.1362-6(b)(2)(iv): §2.36

1.1402(a)-4(b)(2): §3.43

1.1402(a)-4(b)(3)(i): §3.42

1.1402(a)-4(b)(3)(ii): §3.42

1.1402(a)-4(b)(3)(iii): §3.42

1.1402(a)-4(b)(5): §3.45

20.2031-1(b): §§1.14, 3.18, 4.31, 7.45, 7.57

20.2031-2—20.2031-3: §§2.5, 2.10-2.11

20.2031-2(a): §2.4

20.2031-2(e): §9.18

20.2031-2(h): §§1.25, 2.9

20.2031-3: §2.9

20.2031-6: §§7.44-7.45

20.2031-6(b): §7.45

20.2032A-3(b)(1): §§3.25, 3.59

20.2032A-3(b)(2): §3.23

20.2032A-3(c)(2): §3.56

20.2032A-3(d): §§3.47-3.48

20.2032A-3(e)(1): §§3.41-3.42

20.2032A-3(e)(2): §§3.41, 3.45

20.2032A-3(f): §3.46

20.2032A-3(f)(1): §§3.47-3.48

20.2032A-3(f)(2): §§3.47, 3.49

20.2032A-3(g): §3.45

20.2032A-4(b): §3.35

20.2032A-4(b)(2): §3.35

20.2032A-4(b)(2)(iii): §3.35

20.2032A-4(b)(iv): §3.35

20.2032A-4(b)(v): §3.35

20.2032A-4(d): §3.36

20.2032A-4(d)(1)-(10): §3.36

20.2032A-4(e)(1): §3.35

20.2032A-8(2): §3.29

20.2032A-8(a)(2): §§3.28, 3.52

20.2032A-8(a)(3): §3.51

20.2032A-8(b): §3.53

20.2032A-8(c): §3.7

20.2032A-8(c)(1): §3.55

20.2032A-8(c)(2): §3.55

20.2032A-8(c)(3): §3.55

20.2033-1(b): §3.75

20.2044-1(b): §3.103

20.2055-1(a)(4): §7.42

20.2055-2(e)(1)(ii): §7.43

20.2055-5(b): §7.42

20.2056(b)-1(b): §8.32

20.2056(b)-1(c): §§8.21, 8.32

20.2056(b)-4(c)(4): §5.16A

20.2056(b)-7(b)(2)(ii)(B)-(C): §5.20

20.2056(b)-7(d)(1): §5.20

20.2056(b)-7(d)(3): §5.20

20.2056(b)-7(h), Example 6: §5.20

20.6166-1(b): §3.91

20.6166-1(d): §3.92

25.2503-1: §10.10

25.2503-3: §4.30

25.2503-3(b): §10.10

25.2511-1(e): §7.30

25.2512-1: §§1.14, 4.31, 7.44-7.45

25.2512-2(f)(2): §1.39

25.2513-1(c): §4.30

25.2522(c)-3(c)(1): §7.30

25.2522(c)-3(c)(1)(ii): §7.43

25.2701-1(c)-(d): §1.23

25.2701-1(c)(3): §1.23

25.2701-2(b)(5): §§1.27-1.28, 2.5, 2.7

25.2702-2(b): §1.24

25.2702-3(b)(4): §9.31C

25.2702-3(d)(6): §2.24

25.2702-3(e), Example 5: §2.23

25.2702-5(a): §4.20

25.2702-5(c): §4.21

25.2702-5(c)(2)(i): §4.21

25.2702-5(c)(2)(i)(B): §4.21

25.2702-5(c)(2)(i)(C): §4.21

25.2702-5(c)(2)(ii): §4.21

25.2702-5(c)(5)(ii)(A): §4.21

25.2702-5(c)(7)(i): §4.21

25.2702-5(c)(9): §4.22

25.2703-1: §2.5

25.2703-1(b)(1)(i): §2.6

25.2703-1(b)(1)(ii): §2.7

25.2703-1(b)(1)(iii): §2.8

25.2703-1(b)(3): §§2.5, 2.7

25.2703-1(b)(4)(i): §2.8

25.2703-1(b)(4)(ii): §2.8

25.2704-2(b): §1.28

26.2642-2(b): §3.68

53.4942(a)-2(c)(1): §7.39

53.4942(b)-1: §§7.14, 7.18

53.4942(b)-1(a)(1): §7.36

53.4942(b)-1(a)(1)(ii): §7.37

53.4942(b)-1(b)(1): §7.37

53.4942(b)-1(c): §7.41

53.4942(b)-2(a): §7.38

53.4942(b)-2(a)(6), Example 4: §§7.38-7.39

53.4942(b)-2(b)(1): §7.40

53.4942(b)-2(c)(1): §7.41

53.4942(b)-2(c)(2)(ii): §7.41

53.4942(b)(2)(i): §7.37

53.4942(d), Example 1: §7.37

201.10(c): §8.17

301.6501(c)-1(f)(2)-(3): §1.40

301.7701-1—301.7701-3: §§1.9, 4.17

301.7701-2(c): §1.6

301.7701-3: §1.9

TEMPORARY TREASURY REGULATIONS

1.1092(b)-2T(a)(1): §9.40

1.1092(b)-2T(a)(2): §9.40

PROPOSED TREASURY REGULATIONS

20.2036-2(c): §9.31

Regulatory Actions

FEDERAL REGISTER

73 Fed Reg 45908 (2008): §7.19

Rules

SECURITIES AND EXCHANGE COMMISSION (SEC) RULES AND RELEASES

Exchange Act Rules

10b-5: §§9.3-9.4, 9.13

10b5-1: §§9.4, 9.10, 9.24, 9.27, 9.36, 9.60

13(d): §9.31D

16(b): §9.31C

16c-4: §§9.42, 9.60

Securities Act Rules

144: §§9.3, 9.5-9.9, 9.11-9.13, 9.18, 9.24-9.29, 9.31A, 9.31C-9.31D, 9.32-9.35, 9.38, 9.42-9.43, 9.46, 9.50, 9.60, 10.31

144(a)(2): §9.11

144(d): §9.27

144(d)(1): §10.31

144(d)(3)(vi): §9.32

144(e)(3)(iii): §9.25

144(k): §9.31C

145: §§9.3, 9.11

701(c)(3): §§10.19, 10.31

SEC Releases

33-8869 (Dec. 6, 2007): §§9.5, 9.8

33-6099 (Aug. 2, 1979)

Question 31: §9.32

Question 33: §9.33

34-18114 (Sept. 23, 1981): §9.26

FINANCIAL ACCOUNTING STANDARDS (FAS)

123: §§10.21, 10.25

123(R): §§10.21-10.22, 10.25-10.27

Accounting Standards Codification (ASC)

718: §9.17

Rulings

REVENUE RULINGS

2008-44: §3.35

2006-34: §§3.83-3.83A, 3.84

2004-77: §1.8

2004-64: §§2.21, 2.27

2004-60: §§10.33-10.35

2004-37: §9.17

2003-7: §§9.40, 9.42, 9.46

2002-22: §10.33

98-21: §§10.12, 10.14-10.15, 10.29

93-12: §1.36

89-30: §3.37

87-122: §§3.33, 3.52

86-109: §10.41

85-73: §3.117

85-43: §3.105

85-13: §§9.31, 9.31C, 9.32

84-76: §3.115

82-140: §3.29

81-220: §3.28

80-202: §3.80

79-109: §4.27

78-409: §4.27

78-182: §§9.40, 9.51

77-225: §7.30

76-486: §6.29

76-165: §7.31

76-23: §3.104

75-367: §3.83A

75-366: §§3.83-3.84

75-365: §3.83A

75-361: §3.77

75-11: §3.75

74-600: §7.39

74-498: §7.39

73-610: §§7.31-7.32

73-524: §9.42

71-33: §8.18

68-124: §9.18

68-109: §8.22

64-289: §3.75

60-227: §8.18

59-60: §§1.39, 2.39, 4.32, 8.22

58-436: §§3.14, 3.75

58-243: §1.8

57-293: §7.27

54-599: §8.18

REVENUE PROCEDURES

2009-50: §§3.11, 3.19, 3.32, 3.52, 3.72, 3.81, 4.30, 10.10

2008-66: §§3.1, 3.11, 3.19, 3.32, 3.52, 3.71-3.72, 3.81, 4.30, 10.10

2003-43: §2.36

2001-38: §5.20

98-34: §§10.14, 10.20-10.23, 10.26, 10.28-10.30

§3: §10.21

§4.02: §10.21

§4.03: §§10.24-10.25

§4.04: §10.24

§4.05: §10.26

§4.06: §10.27

96-15: §7.47

94-3: §7.33

65-19: §7.54

64-19: §§3.71-3.72

Internal Revenue Service

COORDINATED ISSUE PAPER

LMSB-04-1207-077 (Feb. 6, 2008): §9.46

FIELD SERVICE ADVICE

200143004: §1.30

IRS LETTER RULINGS

200911009: §3.40

200822011: §4.22

200721006: §3.91

200709011: §9.31

200626043: §4.21

200608012: §3.59

200604033: §9.46

200528019: §3.50

200523015: §3.50

200513014: §3.50

200448006: §3.32

200418005: §4.25

200418002: §§7.27, 7.54, 7.60

200247001: §9.57

200241039: §4.21

200236021: §5.20

200223013: §§7.27, 7.30, 7.60

200126026: §4.21

200012076: §9.58

199944003: §1.3

199931028: §4.22

199918049: §4.21

9842003: §1.30

9833011: §7.17

9803009: §9.32

9751003: §4.30

9741004: §4.21

9737016: §10.29

9735011: §4.22

9734034: §9.25

9730013: §4.21

9730004: §1.30

9725002: §1.30

9723009: §1.30

9710021: §§4.28, 4.30

9639064: §4.21

9626041: §4.22

9549023: §8.18

9544018: §4.21

9503025: §4.21

9452026: §§7.17, 7.33

9442019: §4.21

9442017: §7.35

9436017: §9.42

9436005: §1.21

9415007: §§1.37A, 4.28, 4.30

9414012: §2.13

9403005: §9.57

9340009: §4.21

9338042: §7.39

9336002: §4.32

9319005: §9.42

9310039: §1.37A

9303007: §7.27

9236035: §7.39

9222043: §2.7

9152005: §7.59

9146002: §3.12

9140055: §2.34

9138024: §7.35

9131006: §§4.28, 4.30

8845059: §7.39

8824001: §7.39

8727001: §3.10

8611004: §§4.28, 4.30

8601007: §9.42

8536022: §7.17

8535019: §7.26

8441006: §3.28

8439005: §7.17

8422011: §3.71

8412014: §3.29

8407006: §3.28

8346046: §3.71

8346006: §3.28

8333019: §§7.17, 7.26

8332012: §3.28

8327009: §3.5

8321007: §3.28

8318070: §3.2

8314005: §3.71

8314001: §3.71

8244003: §3.84

8220119: §3.94

8209004: §3.29

8208059: §7.17

8146020: §3.29

8143029: §7.17

8009027: §7.17

7934082: §§7.17, 7.27

7917006: §3.84

7911109: §7.17

7830022: §8.18

7751044: §7.17

7730015: §7.35

7728046: §7.27

4.48.2: §7.46

4.48.2.1: §7.46

4.48.2.1.1: §7.46

IRS NOTICES

2008-2: §9.46

2007-90: §3.99

2007-50: §3.119A

2006-96: §§7.19-7.21

§3.01: §7.20

§3.03(1): §7.21

§3.03(2): §7.21

§3.03(3): §7.21

2003-72: §2.23

2003-47: §10.32

2002-31: §§10.33-10.35

OUT-OF-STATE STATUTESAND ACTS

Alabama Code

§40-15-2: §5.26

Alaska Stat

§43.31.011: §5.26

Arizona Rev Stat

§42 ch 4 (former): §5.26

§43-1332: §5.26

Arkansas Code Ann

§26-59-103: §5.26

Colorado Rev Stat

§39-23.5-102: §5.26

§39-23.5-103: §5.26

Connecticut Gen Stat

§12-391: §5.26

Delaware Code Ann Tit 30

§1501: §5.26

§1502: §5.26

District of Columbia Code Ann

§47-3701: §§5.10, 5.26

§47-3702: §5.26

Florida Stat Ann

§198.02: §5.26

Georgia Code Ann

§48-12-2: §5.26

Hawaii Rev Stat

§236D-2: §5.26

§236D-3: §5.26

Idaho Code

§14-402: §5.26

§14-403: §5.26

§63-3004: §5.26

Illinois Comp Stat Tit 35

§405/2: §5.26

§405/3: §5.26

Indiana Code

§6-4.1-1-4: §5.26

§6-4.1-11-2: §5.26

Iowa Code

§422.3: §5.26

Kansas Stat Ann

§79-15, 101 (former): §5.26

§79-15, 102 (former): §5.26

§79-15, 203: §5.26

§79-15, 253: §5.26

Kentucky Rev Stat Ann

§140.010: §5.26

§140.130: §5.26

Louisiana Rev Stat Ann

§47:2401: §5.26

§47:2431: §5.26

§47:2432: §5.26

Maine Rev Stat Ann Tit 36

§§4061-4062: §5.10

§4062: §5.26

§4063: §5.26

§4063-A: §5.26

Maryland Code Ann Tax-Gen

§7-304: §5.26

§7-309: §5.26

Massachusetts Gen Laws Ch 65C

§2A(a): §§5.10, 5.26

§3: §§5.10, 5.26

Michigan Comp Laws

§205.232: §5.26

§205.256: §5.26

Minnesota Stat

§289A.10(1): §5.10

§289A.10(1)-(2): §5.26

§291.005: §5.26

§291.03: §§5.10, 5.26

Mississippi Code Ann

§27-9-5: §5.26

Missouri Rev Stat

§145.011: §5.26

§145.091: §5.26

Montana Code Ann

§72-16-904: §5.26

§72-16-905: §5.26

Nebraska Rev Stat

§49-801.01: §5.26

§77-2101: §§5.10, 5.26

§77-2101.01: §5.26

§77-2101.03: §5.26

Nevada Rev Stat Ann

§375A.025: §5.26

§375A.100: §5.26

New Hampshire Stat Ann

§87.1: §5.26

§87.7: §5.26

New Jersey Stat Ann

§54:33-1: §5.26

§54:38-1: §§5.10, 5.16A, 5.17, 5.26

New Mexico Stat Ann

§7-7-2: §5.26

§7-7-3: §5.26

New York Tax Laws

§951: §5.10

§§951-952: §5.26

§952: §5.5

§952 (former): §5.5

§960: §§5.5, 5.26

North Carolina Gen Stat

§105-32.1: §5.26

§105-32.2: §5.26

§105-228.90: §5.26

North Dakota Cent Code

§57-37.1-04: §5.26

Ohio Rev Code Ann

§5731.02: §5.26

§5731.18: §5.26

Oklahoma Stat Tit 68

§804: §5.26

§809: §5.26

Oregon Rev Stat

§118.005(10): §5.26

§118.007: §5.26

§118.009: §5.26

§118.010: §5.26

§118.160: §5.26

Pennsylvania Cons Stat Tit 72

§9102: §5.26

§9117: §5.26

Rhode Island Gen Laws

§44-22-1.1: §§5.3, 5.10, 5.26

South Carolina Code Ann

§12-6-40: §5.26

§12-16-510: §5.26

§12-16-20: §5.26

South Dakota Codified Laws

§10-40A-1: §5.26

§10-40A-3: §5.26

Tennessee Code Ann

§67-8-202: §5.26

§67-8-203: §5.26

Texas Tax Code Ann

§211.001: §5.26

§211.003: §5.26

§211.051: §5.26

Utah Code Ann

§59-11-102: §5.26

§59-11-103: §5.26

Vermont Stat Ann Tit 32

§7402(8): §5.26

§7442a: §5.26

§7475: §5.26

Virginia Code Ann

§58.1-901: §5.26

§58.1-902: §5.26

Washington Rev Code

§83.100.020: §5.26

§83.100.040: §5.26

West Virginia Code

§11-11-3: §5.26

Wisconsin Stat

§72.01: §§5.10, 5.26

§72.02: §5.26

Wyoming Stat Ann

§39-19-103: §5.26

§39-19-104: §5.26

INTERNATIONAL

Berne Convention for the Protection of Literary and Artistic Works of 1886: §8.4

Statute of Anne: §8.2

© The Regents of the University of California

Table of Cases

A

A. Rick D'Arcangelo, TC Memo 1994-572: §7.19

Abell, Flora J., Estate of (1984) 83 TC 696: §3.25

Abraham Cohen, Estate of (1982) 79 TC 1015: §1.37A

Abraham, Ida, Estate of, TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26, cert denied (2006) 547 US 1178: §1.37A

Adams v U.S. (5th Cir 2000) 218 F3d 383: §§1.3, 1.15

Ahmanson Found. v U.S. (9th Cir 1981) 674 F2d 761: §§7.60, 9.57

Albert Strangi, Estate of (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom Gulig v Commissioner (5th Cir 2002) 293 F3d 279 (Strangi I): §§1.34-1.35

Albert Strangi, Estate of, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (Strangi II): §§1.34-1.35, 1.37-1.37B, 4.28, 4.34, 9.33

Albert Victor Mills, TC Memo 1991-592: §7.61

Aldo H. Fontana, Estate of (2002) 118 TC 318: §3.10

Alexis M. Hawkins, TC Memo 1982-451: §7.61

Alto B. Cervin, Estate of, TC Memo 1994-550, rev'd on other grounds (5th Cir 1997) 111 F3d 1252: §§4.21, 4.32-4.33

Andrews, Woodbury G., Estate of (1982) 79 TC 938, superseded by statute on other grounds as stated in Eisenberg v Commissioner (2d Cir 1998) 155 F3d 50: §§1.14-1.16, 1.36

Anna Mirowski, Estate of, TC Memo 2008-74: §§1.37A-1.37C, 4.34

Anselmo, Ronald P. (1983) 80 TC 872, aff'd (11th Cir 1985) 757 F2d 1208: §§7.45, 7.48-7.49

Anthony J. Frank, Sr., Estate of, TC Memo 1995-132: §§1.33, 4.21

Arbini, Jearold E., TC Memo 2001-141: §7.61

Artemus D. Davis, Estate of (1998) 110 TC 530: §1.14

Ashkar, Fuad S., TC Memo 1991-11: §7.55

Aslteford, Jane Z., TC Memo 2008-128: §1.3

Astaire v Best Film & Video Corp. (9th Cir 1997) 116 F3d 1297, cert denied (1998) 119 S Ct 161: §8.35

Atkins, George Herbert, Estate of (1943) 2 TC 332: §2.4

Audrey J. Walton (2000) 115 TC 589, acq 2003-2 Cum Bull 964: §2.23

Austin Korby, Estate of, TC Memo 2005-103, aff'd (8th Cir 2006) 471 F3d 848: §1.37A

B

Baine P. Kerr (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490: §1.32

Baird, John L., Estate of, TC Memo 2001-258: §4.32

Baker, Thomas J., TC Memo 1990-263: §7.61

Beam v Bank of America (1971) 6 C3d 12, 98 CR 137: §2.12

Bennett, Charles Russell, Estate of, TC Memo 1993-34: §1.15

Bennett, Dorian M., TC Memo 1991-604: §7.61

Berg, Edgar A., Estate of, TC Memo 1991-279, aff'd in part and rev'd in part on other grounds (8th Cir 1992) 976 F2d 1163: §1.38

Bernard Lightman, TC Memo 1985-315: §7.50

Bernard Mandelbaum, TC Memo 1995-255, aff'd (3d Cir 1996) 91 F3d 124: §1.39

Biagiotti, Raymond, TC Memo 1986-460: §§7.48, 7.53, 7.61

Bigelow, Estate of v Commissioner (9th Cir 2007) 503 F3d 955: §4.34

Bigelow, Virginia A., Estate of, TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955: §§1.37A-1.37C

Blount, Estate of v Commissioner (11th Cir 2005) 428 F3d 1338: §2.4

Bodizar M. Raznatovich, TC Memo 1980-436: §7.61

Bommer, Cameron W., Revocable Trust, TC Memo 1997-380: §2.7

Bond, Dewayne (1993) 100 TC 32: §7.19

Bongard, Wayne C., Estate of (2005) 124 TC 95: §§1.37-1.37B, 4.34, 9.33

Bright, Estate of v U.S. (5th Cir 1981) 658 F2d 999: §§1.14, 1.36

Bronson, Robert E., III, TC Memo 1992-122: §7.61

Bruce Korson, TC Memo 1998-132: §7.61

Burroughs v Metro-Goldwyn-Mayer, Inc. (SD NY 1980) 491 F Supp 1320: §8.17

Bush, Estate of v U.S. (Ct Cl 1980) 618 F2d 741: §7.42

Byrum v U.S. (SD Ohio 1970) 311 F Supp 892, aff'd (6th Cir 1971) 440 F2d 949, aff'd (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382: §1.22

Byrum, U.S. v (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382: §1.37A

C

Calder, Louisa J. (1985) 85 TC 713: §7.51

Cameron W. Bommer Revocable Trust, TC Memo 1997-380: §2.7

Capano Music v Myers Music, Inc. (SD NY 1985) 605 F Supp 692: §§8.20, 8.22

Carita M. Clinard, Estate of (1986) 86 TC 1180: §§3.28-3.29

Cazeres v Saenz (1989) 208 CA3d 279, 256 CR 209: §11.15

Cervin, Alto B., Estate of, TC Memo 1994-550, rev'd on other grounds (5th Cir 1997) 111 F3d 1252: §§4.21, 4.32-4.33

Charles Porter Schutt, Estate of, TC Memo 2005-126: §§1.37B, 4.34

Charles Russell Bennett, Estate of, TC Memo 1993-34: §1.15

Charles W. Ward (1986) 87 TC 78: §2.39

Childress v Taylor (2d Cir 1991) 945 F2d 500: §8.7

Chou, Jack C., TC Memo 1990-90: §7.55

Christine M. Hackl (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664: §§1.3, 4.30

Chronicle Publ'g Co. v Commissioner (1991) 97 TC 445, aff'd (5th Cir 1993) 983 F2d 232 (unpublished opinion): §7.61

Church v U.S. (WD Tex 2000) 2000-1 USTC ¶60,369, 85 AFTR2d 804, aff'd (5th Cir 2001) 268 F3d 1063 (unpublished opinion): §§1.34-1.35, 1.41

Clara S. Roeder Winkler, Estate of, TC Memo 1989-231: §1.21

Clarissa W. Lappo, TC Memo 2003-258: §1.16

Classic Media, Inc. v Mewborn (9th Cir 2008) 532 F3d 978: §8.15E

Clayton, Estate of v Commissioner (5th Cir 1992) 976 F2d 1486: §5.20

Clifton E. Peterson, TC Memo 1982-438: §7.61

Clinard, Carita M., Estate of (1986) 86 TC 1180: §§3.28-3.29

Cohen, Abraham, Estate of (1982) 79 TC 1015: §1.37A

Coleman, Philip G., TC Memo 1988-538: §7.17

Commissioner v Sunnen (1948) 333 US 591, 92 L Ed 898, 68 S Ct 715: §8.18

Conrad Janis, TC Memo 2004-117: §7.61A

Cooley, Jacob J. (1959) 33 TC 223, aff'd (2d Cir 1960) 283 F2d 945: §7.60

Cyril I. Magnin, Estate of, TC Memo 2001-31: §1.21

D

Dale B. Dubin, TC Memo 1986-433: §7.49

Daniel D. Palmer (1974) 62 TC 684, aff'd (8th Cir 1975) 523 F2d 1308, acq 1978-1 Cum Bull 83: §7.33

Daniel I. Rhode, TC Memo 1990-656: §7.61

Daniel J. Harrison, Jr., Estate of, TC Memo 1987-8: §1.27

D'Arcangelo, A. Rick, TC Memo 1994-572: §7.19

Darwin A. Miller, Estate of, TC Memo 1991-515: §7.61

David Davis IV, Estate of (1986) 86 TC 1156: §3.28

Davis, Artemus D., Estate of (1998) 110 TC 530: §1.14

Davis, David, IV, Estate of (1986) 86 TC 1156: §3.28

Deputy, Helen A., Estate of, TC Memo 2003-176: §1.16

Deukmejian, George, TC Memo 1981-24: §7.60

Dewayne Bond (1993) 100 TC 32: §7.19

DiSanto, Frank M., Estate of, TC Memo 1999-421: §7.60

Disbrow, Lorraine C., Estate of, TC Memo 2006-34: §1.37A

Doherty, George O., TC Memo 1992-98, aff'd (9th Cir 1994) 16 F3d 338: §7.58

Donoghue v Centillium Communications, Inc. (SD NY, Mar. 28, 05 Civ 4082) 2006 US Dist Lexis 13221: §9.46

Dorian M. Bennett, TC Memo 1991-604: §7.61

Dorothy Morganson Schauerhamer, Estate of, TC Memo 1997-242: §4.34

Dreiling v Jain (WD Wash 2003) 281 F Supp 2d 1234: §§9.31C, 9.60

Dreiling v Kellett (WD Wash 2003) 281 F Supp 2d 1215: §9.31C

Dubin, Dale B., TC Memo 1986-433: §7.49

Dudchik, In re (Dec. 5, 2008, No. 3-12943) 2008 SEC Lexis 2856: §9.5

Dunn, Estate of v Commissioner (5th Cir 2002) 301 F3d 339: §1.14

E

Edgar A. Berg, Estate of, TC Memo 1991-279, aff'd in part and rev'd in part on other grounds (8th Cir 1992) 976 F2d 1163: §1.38

Edward P. Roski, Sr., Estate of (2007) 128 TC 113: §3.99

Eisenberg v Commissioner (2d Cir 1998) 155 F3d 50, acq 1999-1 Cum Bull xix: §1.14

Eldred v Ashcroft (2003) 537 US 186, 154 L Ed 2d 683, 123 S Ct 769: §8.3

Elizabeth B. Murphy, Estate of, TC Memo 1990-472: §§1.3, 1.30, 1.33, 1.41

Elizabeth G. Augustus (1939) 40 BTA 1201, aff'd (6th Cir 1941) 118 F2d 38: §7.61A

Elizabeth M. Lee, Estate of (1978) 69 TC 860, nonacq 1980-2 Cum Bull 2: §1.36

Ellie B. Williams, Estate of, TC Memo 1998-59: §4.32

Ellis, In re Domestic Partnership of (2008) 162 CA4th 1000, 76 CR3d 401: §8.15C

Emma V. Jorgensen, Estate of, TC Memo 2009-66: §§1.37B, 4.34

Engel, George H., TC Memo 1993-362: §7.61

Erickson v Trinity Theatre, Inc. (7th Cir 1994) 13 F3d 1061: §8.7

Erickson, Hilde E., Estate of, TC Memo 2007-107: §§1.37A, 4.34

Estate of _____ (*see* name of decedent)

Ethel S. Nowell, Estate of, TC Memo 1999-15: §1.3

Eugene E. Stone III, Estate of, TC Memo 2003-309: §§1.37B, 4.34

Evers, Henry M., Estate of, TC Memo 1989-292: §3.71

F

Ferrari, Heriberto A., TC Memo 1989-521: §7.53

Finnegan v Finnegan (1944) 64 CA2d 109, 148 P2d 37: §8.29

Fisher, Fred, Music Co. v M. Witmark & Sons (1943) 318 US 643, 87 L Ed 1055, 63 S Ct 773: §§8.3, 8.15D-8.15E

Flora J. Abell, Estate of (1984) 83 TC 696: §3.25

Fontana, Aldo H., Estate of (2002) 118 TC 318: §3.10

Ford, Quintin U., TC Memo 1983-556: §§7.9, 7.48

Fracasse v Brent (1972) 6 C3d 784, 100 CR 385: §§11.13, 11.15

Frances E. Wherry Maddox, Estate of (1989) 93 TC 228: §3.32

Frank M. DiSanto, Estate of, TC Memo 1999-421: §7.60

Frank, Anthony J., Sr., Estate of, TC Memo 1995-132: §§1.33, 4.21

Franklin P. Perdue, TC Memo 1991-478: §7.57

Frates, Richard E., TC Memo 1987-79: §7.61

Fred Fisher Music Co. v M. Witmark & Sons (1943) 318 US 643, 87 L Ed 1055, 63 S Ct 773: §§8.3, 8.15D-8.15E

Frederick C. Johnson (1985) 85 TC 469: §7.61

Fuad S. Ashkar, TC Memo 1991-11: §7.55

G

Gavin, Estate of v U.S. (8th Cir 1997) 113 F3d 802: §3.60

George Deukmejian, TC Memo 1981-24: §7.60

George H. Engel, TC Memo 1993-362: §7.61

George Herbert Atkins, Estate of (1943) 2 TC 332: §2.4

George O. Doherty, TC Memo 1992-98, aff'd (9th Cir 1994) 16 F3d 338: §7.58

Georgina T. Gimbel, Estate of, TC Memo 2006-270: §9.28

Gerald D. Leibowitz, TC Memo 1977-243: §7.61

Gifford M. Mast, Jr., TC Memo 1989-119: §7.52

Gifford M. Mast, Jr., TC Memo 1989-438: §7.52

Gilford, Saul R., Estate of (1987) 88 TC 38: §9.28

Gimbel, Georgina T., Estate of, TC Memo 2006-270: §9.28

Glass v Commissioner (6th Cir 2006) 471 F3d 698: §3.119

Glen, William (1982) 79 TC 208: §§7.9, 7.61

Gloeckner, Estate of v Commissioner (2d Cir 1998) 152 F3d 208: §§2.9-2.11

Godley, Estate of v Commissioner (4th Cir 2002) 286 F3d 210: §1.16

Gregg Maxcy, Estate of, TC Memo 1969-158, rev'd on other grounds (5th Cir 1971) 441 F2d 192: §1.15

H

Hackl, Christine M. (2002) 118 TC 279, aff'd (7th Cir 2003) 335 F3d 664: §§1.3, 4.30

Hall, Joyce C., Estate of (1989) 92 TC 312: §2.6

Hall, Robert A., TC Memo 1990-127: §7.61

Harper, Morton B., Estate of, TC Memo 2000-202: §1.32

Harper, Morton B., Estate of, TC Memo 2002-121: §§1.32, 1.37A, 4.34

Harriett R. Mellinger, Estate of (1999) 112 TC 26, acq 1999-2 Cum Bull xvi, corrected Announcement 99-116, 1999-2 Cum Bull 763: §3.10

Harrison, Daniel J., Jr., Estate of, TC Memo 1987-8: §1.27

Harry D. Mandelbaum, TC Memo 1990-223: §7.61

Harwood, Virginia Z. (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion): §§1.14, 1.16

Hawkins, Alexis M., TC Memo 1982-451: §7.61

Heckerman v U.S. (WD Wash 2009) 2009-2 USTC ¶60,578, 104 AFTR2d 5551: §1.37D

Heffley, Opal P., Estate of (1987) 89 TC 265, aff'd (7th Cir 1989) 884 F2d 279: §§3.25, 3.60

Helen A. Deputy, Estate of, TC Memo 2003-176: §1.16

Henry M. Evers, Estate of, TC Memo 1989-292: §3.71

Heriberto A. Ferrari, TC Memo 1989-521: §7.53

Herman v U.S. (DC Tenn 1999) 73 F Supp 2d 912: §7.50

Hernandez v Peer Int'l Corp. (D PR 2003) 270 F Supp 2d 207: §8.22

Hilde E. Erickson, Estate of, TC Memo 2007-107: §§1.37A, 4.34

Hillgren, Lea K., Estate of, TC Memo 2004-46: §1.37A

Holman, Thomas H. (2008) 130 TC 170: §§1.25, 1.34, 1.37D, 1.39

Holtzman, Paul W., TC Memo 1980-174: §7.55

Hoover, Estate of v Commissioner (10th Cir 1995) 69 F3d 1044, acq 1998-2 Cum Bull 254: §§3.31-3.32

Hunter, Samuel E., TC Memo 1986-308: §§7.50, 7.56

Hurford, Thelma G., Estate of, TC Memo 2008-278: §1.37B

I

Ida Abraham, Estate of, TC Memo 2004-39, aff'd (1st Cir 2005) 408 F3d 26, cert denied (2006) 547 US 1178: §1.37A

In re Domestic Partnership of Ellis (2008) 162 CA4th 1000, 76 CR3d 401: §8.15C

In re Dudchik (Dec. 5, 2008, No. 3-12943) 2008 SEC Lexis 2856: §9.5

Ina F. Knight (2000) 115 TC 506: §§1.33, 1.41, 4.33

Isaacs, Joseph M., TC Memo 1991-473: §7.56

Isbell, Larry M., TC Memo 1982-534: §§7.16, 7.61

Iskenderian v Iskenderian (2006) 144 CA4th 1162, 51 CR3d 163: §§8.33H-8.33I

J

Jack C. Chou, TC Memo 1990-90: §7.55

Jacob J. Cooley (1959) 33 TC 223, aff'd (2d Cir 1960) 283 F2d 945: §7.60

Jacobson, Samuel, TC Memo 1999-401: §7.61

James H. Rhoades, TC Memo 1988-279: §7.50

James L. Winokur (1988) 90 TC 733, acq 1989-2 Cum Bull 1: §§7.26, 7.61

Jameson, Estate of v Commissioner (5th Cir 2001) 267 F3d 366: §1.14

Jane Z. Aslteford, TC Memo 2008-128: §1.3

Janis v Commissioner (2d Cir 2006) 469 F3d 256: §7.61A

Janis v Commissioner (9th Cir 2006) 461 F3d 1080: §7.61A

Janis, Conrad, TC Memo 2004-117: §7.61A

Jennings, Raymond Dean, TC Memo 1988-521: §§7.17, 7.50

Jearold E. Arbini, TC Memo 2001-141: §7.61

Jere J. Solvie, TC Memo 2004-55: §3.43

John L. Baird, Estate of, TC Memo 2001-258: §4.32

John L. Louderback, TC Memo 1995-19: §7.19

John V. Wehausen (1988) TC Memo 1988-460: §7.61

Johnson, Frederick C. (1985) 85 TC 469: §7.61

Jones, W.W., II, Estate of (2001) 116 TC 121: §§1.34-1.35

Jorgensen, Emma V., Estate of, TC Memo 2009-66: §§1.37B, 4.34

Joseph H. Lauder, Estate of, TC Memo 1992-736: §§2.11, 3.16

Joseph M. Isaacs, TC Memo 1991-473: §7.56

Josephine T. Thompson, Estate of, TC Memo 2004-174, vacated and remanded (2d Cir 2007) 499 F3d 129, cert denied (2008)

___ US ___, 171 L Ed 2d 863, 128 S Ct 2932: §1.39

Joyce C. Hall, Estate of (1989) 92 TC 312: §2.6

K

Keller v U.S. (SD Tex 2009) 2009-2 USTC ¶60,579, 104 AFTR2d 6015: §1.37B

Kelley, Webster E., Estate of, TC Memo 2005-235: §1.37C

Kenan v Commissioner (2d Cir 1940) 114 F2d 217: §3.111

Kern County Land Co. v Occidental Petroleum Corp. (1973) 411 US 582, 36 L Ed 2d 503, 93 S Ct 1736: §9.33

Kerr, Baine P. (1999) 113 TC 449, aff'd (5th Cir 2002) 292 F3d 490: §1.32

Kimbell v U.S. (5th Cir 2004) 371 F3d 257: §§1.37A-1.37B, 4.34

Knight, Ina F. (2000) 115 TC 506: §§1.33, 1.41, 4.33

Koebke v Bernardo Heights Country Club (2005) 36 C4th 824, 31 CR3d 565: §8.15C

Korby, Austin, Estate of, TC Memo 2005-103, aff'd (8th Cir 2006) 471 F3d 848: §1.37A

Korson, Bruce, TC Memo 1998-132: §7.61

Krauskopf, Noris W., TC Memo 1984-386: §7.61

Kwok v Transnation Title Ins. Co. (2009) 170 CA4th 1562, 89 CR3d 141: §1.52

L

Lappo, Clarissa W., TC Memo 2003-258: §1.16

Lauder, Joseph H., Estate of, TC Memo 1992-736: §§2.11, 3.16

Larry M. Isbell, TC Memo 1982-534: §§7.16, 7.61

Lea K. Hillgren, Estate of, TC Memo 2004-46: §1.37A

Lee, Elizabeth M., Estate of (1978) 69 TC 860, nonacq 1980-2 Cum Bull 2: §1.36

LeFrak, Samuel J., TC Memo 1993-526: §§4.21, 4.32-4.33

Leibowitz, Gerald D., TC Memo 1977-243: §7.61

Lightman, Bernard, TC Memo 1985-315: §7.50

Linton v U.S. (WD Wash 2009) 2009-2 USTC ¶60,575, 104 AFTR2d 5176: §1.37D

Lio, Peter J. (1985) 85 TC 56: §7.61

Lorraine C. Disbrow, Estate of, TC Memo 2006-34: §1.37A

Louderback, John L., TC Memo 1995-19: §7.19

Louisa J. Calder (1985) 85 TC 713: §7.51

Lucas v Hamm (1961) 56 C2d 583, 15 CR 821: §3.1A

Lugosi v Universal Pictures (1979) 25 C3d 813, 160 CR 323: §8.35

M

Maddox, Frances E. Wherry, Estate of (1989) 93 TC 228: §3.32

Magnin, Cyril I., Estate of, TC Memo 2001-31: §1.21

Mandelbaum, Bernard, TC Memo 1995-255, aff'd (3d Cir 1996) 91 F3d 124: §1.39

Mandelbaum, Harry D., TC Memo 1990-223: §7.61

Maniscalco v Commissioner (6th Cir 1980) 632 F2d 6: §7.13

Marriage of Steinberger (2001) 91 CA4th 1449, 111 CR2d 521: §10.33

Marriage of Worth (1987) 195 CA3d 768, 241 CR 135: §8.13

Martin v Commissioner (7th Cir 1986) 783 F2d 81: §3.25

Martin, Mary Jean (1985) 84 TC 620, aff'd (7th Cir 1986) 783 F2d 81: §3.60

Marvel Characters, Inc. v Simon (2d Cir 2002) 310 F3d 280: §§8.15B, 8.15E

Marvin F. Pullin, Estate of (1985) 84 TC 789, acq 1988-2 Cum Bull 1: §3.7

Marvin M. Schwan, Estate of, TC Memo 2001-174: §7.60

Mary Jean Martin (1985) 84 TC 620, aff'd (7th Cir 1986) 783 F2d 81: §3.60

Mast, Gifford M., Jr., TC Memo 1989-119: §7.52

Mast, Gifford M., Jr., TC Memo 1989-438: §7.52

Maxcy, Gregg, Estate of, TC Memo 1969-158, rev'd on other grounds (5th Cir 1971) 441 F2d 192: §1.15

May v Morganelli-Heumann & Assocs. (9th Cir 1980) 618 F2d 1363: §8.8

McClatchy, Estate of v Commissioner (9th Cir 1998) 147 F3d 1089: §§9.18, 9.28

McCord v Commissioner (5th Cir 2006) 461 F3d 614: §1.38

McLendon, Estate of (5th Cir 1995) 96-1 USTC ¶60,220, 77 AFTR2d 666: §1.3

McNamara v Commissioner (8th Cir 2000) 236 F3d 410: §3.43

Meisner v U.S. (8th Cir 1998) 133 F3d 654: §8.18

Mellinger, Harriett R., Estate of (1999) 112 TC 26, acq 1999-2 Cum Bull xvi, corrected Announcement 99-116, 1999-2 Cum Bull 763: §3.10

Messing, Morris M. (1967) 48 TC 502, acq 1968-2 Cum Bull 2: §7.52

Miller v Commissioner (5th Cir 1962) 299 F2d 706: §8.35

Miller, Darwin A., Estate of, TC Memo 1991-515: §7.61

Mills, Albert Victor, TC Memo 1991-592: §7.61

Milne v Stephen Slesinger, Inc. (9th Cir 2005) 430 F3d 1036: §§8.15, 8.15E

Minter v U.S. (8th Cir 1994) 19 F3d 426: §3.60

Mirowski, Anna, Estate of, TC Memo 2008-74: §§1.37A-1.37C, 4.34

Moore, Walter J., TC Memo 1968-110: §8.18

Morales v Quintiles Transnational Corp. (SD NY 1998) 25 F Supp 2d 369: §§9.31C, 9.60

Moran v London Records, Ltd. (ND Ill 1986) 642 F Supp 1023, aff'd (7th Cir 1987) 827 F2d 180: §8.8

Morris M. Messing (1967) 48 TC 502, acq 1968-2 Cum Bull 2: §7.52

Morton B. Harper, Estate of, TC Memo 2000-202: §1.32

Morton B. Harper, Estate of, TC Memo 2002-121: §§1.32, 1.37A, 4.34

Murphy, Elizabeth B., Estate of, TC Memo 1990-472: §§1.3, 1.30, 1.33, 1.41

Murphy, Thomas G., TC Memo 1991-276, rev'd on other grounds (9th Cir 1993) 1993 US App Lexis 26485: §7.54

Myron G. Sammons (9th Cir 1988) 838 F2d 330: §7.61

N

Neely, Raph (1985) 85 TC 934: §7.61

Noris W. Krauskopf, TC Memo 1984-386: §7.61

Northwest Energetic Servs. LLC v Franchise Tax Board (2008) 159 CA4th 841, 71 CR3d 642: §5.14

Nowell, Ethel S., Estate of, TC Memo 1999-15: §1.3

O

Opal P. Heffley, Estate of (1987) 89 TC 265, aff'd (7th Cir 1989) 884 F2d 279: §§3.25, 3.60

Orchard, Robert H., TC Memo 1975-31: §7.9

P

Palmer, Daniel D. (1974) 62 TC 684, aff'd (8th Cir 1975) 523 F2d 1308, acq 1978-1 Cum Bull 83: §7.33

Paul W. Holtzman, TC Memo 1980-174: §7.55

Pearl Gibbons Reynolds, Estate of (1970) 55 TC 172, acq 1971-2 Cum Bull 3: §2.39

Penguin Group (USA) Inc. v Steinbeck (2d Cir 2008) 537 F3d 193: §§8.15, 8.15E, 8.16A

Peracchio, Peter S., TC Memo 2003-280: §1.16

Perdue, Franklin P., TC Memo 1991-478: §7.57

Perreira v Perreira (1909) 156 C 1, 103 P 488: §2.12

Peter J. Lio (1985) 85 TC 56: §7.61

Peter S. Peracchio, TC Memo 2003-280: §1.16

Peterson, Clifton E., TC Memo 1982-438: §7.61

Philip G. Coleman, TC Memo 1988-538: §7.17

Pierre, Suzanne J. (2009) 133 TC No. 2: §1.37D

Pliske, Susan L., Estate of, TC Memo 1986-311: §3.28

Propstra v U.S. (9th Cir 1982) 680 F2d 1248: §1.36

Pullin, Marvin F., Estate of (1985) 84 TC 789, acq 1988-2 Cum Bull 1: §3.7

Pye v Mitchell (9th Cir 1978) 574 F2d 476: §8.7

Q

Quintin U. Ford, TC Memo 1983-556: §§7.9, 7.48

R

Rapelje, Estate of (1979) 73 TC 82: §4.27

Raph Neely (1985) 85 TC 934: §7.61

Raymond Biagiotti, TC Memo 1986-460: §§7.48, 7.53, 7.61

Raymond Dean Jennings, TC Memo 1988-521: §§7.17, 7.50

Raznatovich, Bodizar M., TC Memo 1980-436: §7.61

Rebecca A. Wineman, Estate of, TC Memo 2000-193: §§3.10, 3.12, 3.37

Reynolds, Pearl Gibbons, Estate of (1970) 55 TC 172, acq 1971-2 Cum Bull 3: §2.39

Rhoades, James H., TC Memo 1988-279: §7.50

Rhode, Daniel I., TC Memo 1990-656: §7.61

Richard A. Skripak (1985) 84 TC 285: §7.51

Richard B. Skala, TC Memo 1985-1: §7.61

Richard E. Frates, TC Memo 1987-79: §7.61

Robert A. Hall, TC Memo 1990-127: §7.61

Robert C. Scull, Estate of, TC Memo 1994-211: §7.27

Robert E. Bronson, III, TC Memo 1992-122: §7.61

Robert H. Orchard, TC Memo 1975-31: §7.9

Robert L. Sanz, TC Memo 1990-568: §7.61

Rodrigue v Rodrigue (5th Cir 2000) 218 F3d 432, cert denied (2001) 532 US 905: §8.13

Ronald P. Anselmo (1983) 80 TC 872, aff'd (11th Cir 1985) 757 F2d 1208: §§7.45, 7.48-7.49

Roski, Edward P., Sr., Estate of (2007) 128 TC 113: §3.99

Russell, Estate of (1968) 69 C2d 200, 70 CR 561: §6.2

S

Saltzman v U.S. (ED NY 1988) 750 F Supp 61: §7.61

Samuel E. Hunter, TC Memo 1986-308: §§7.50, 7.56

Samuel J. LeFrak, TC Memo 1993-526: §§4.21, 4.32-4.33

Samuel Jacobson, TC Memo 1999-401: §7.61

Sanz, Robert L., TC Memo 1990-568: §7.61

Saul R. Gilford, Estate of (1987) 88 TC 38: §9.28

Schauerhamer, Dorothy Morganson, Estate of, TC Memo 1997-242: §4.34

Schwan, Marvin M., Estate of, TC Memo 2001-174: §7.60

Schutt, Charles Porter, Estate of, TC Memo 2005-126: §§1.37B, 4.34

Scull, Robert C., Estate of, TC Memo 1994-211: §7.27

Senda v Commissioner (8th Cir 2006) 433 F3d 1044: §1.37D

Siegel v Warner Bros. Entertainment, Inc. (CD Cal 2008) 542 F Supp 2d 1098: §8.15D

Simplot, Estate of v Commissioner (9th Cir 2001) 249 F3d 1191: §1.20

Skala, Richard B., TC Memo 1985-1: §7.61

Skripak, Richard A. (1985) 84 TC 285: §7.51

Smith III v U.S. (WD Pa 2004) 2004-2 USTC ¶60,488, 94 AFTR2d 5283: §1.34

Solvie, Jere J., TC Memo 2004-55: §3.43

Southworth, Estate of (1996) 51 CA4th 564, 59 CR2d 272: §6.9

St. Louis County Bank v U.S. (8th Cir 1982) 674 F2d 1207: §2.6

Steinbeck v Penguin Group (USA) Inc. (2009) 173 L Ed 2d 1326, 129 S Ct 238: §8.15E

Steinberger, Marriage of (2001) 91 CA4th 1449, 111 CR2d 521: §10.33

Stevenson, Estate of v Director, Div. of Taxation (2008) 23 NJ Tax 583: §§5.16A, 5.19

Stone v U.S. (ND Cal 2007) 2007-2 USTC ¶60,545, 100 AFTR 2d 5512, aff'd (9th Cir 2009) 2009-1 USTC ¶60,572, 103 AFTR2d 1379: §7.27

Stone, Eugene E., III, Estate of, TC Memo 2003-309: §§1.37B, 4.34

Strangi, Albert, Estate of (2000) 115 TC 478, aff'd in part and rev'd in part on other grounds sub nom Gulig v Commissioner (5th Cir 2002) 293 F3d 279 (Strangi I): §§1.34-1.35

Strangi, Albert, Estate of, TC Memo 2003-145, aff'd (5th Cir 2005) 417 F3d 468 (Strangi II): §§1.34-1.35, 1.37-1.37B, 4.28, 4.34, 9.33

Straw, William E., TC Memo 1991-524: §7.61

Strom v U.S. (WD Wash 2008) 583 F Supp 2d 1264: §9.17

Sunnen, Commissioner v (1948) 333 US 591, 92 L Ed 898, 68 S Ct 715: §8.18

Susan L. Pliske, Estate of, TC Memo 1986-311: §3.28

Suzanne J. Pierre (2009) 133 TC No. 2: §1.37D

T

Taylor v Commissioner (1931) 51 F2d 915: §8.18

Thelma G. Hurford, Estate of, TC Memo 2008-278: §1.37B

Theodore R. Thompson, Estate of, TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367: §§1.33, 1.37A, 4.34

Thomas G. Murphy, TC Memo 1991-276, rev'd on other grounds (9th Cir 1993) 1993 US App Lexis 26485: §7.54

Thomas H. Holman (2008) 130 TC 170: §§1.25, 1.34, 1.37D, 1.39

Thomas J. Baker, TC Memo 1990-263: §7.61

Thompson, Estate of v Commissioner (4th Cir 1989) 864 F2d 1128: §§3.29-3.30

Thompson, Josephine T., Estate of, TC Memo 2004-174, vacated and remanded (2d Cir 2007) 499 F3d 129, cert denied (2008) ___ US ___, 171 L Ed 2d 863, 128 S Ct 2932: §1.39

Thompson, Theodore R., Estate of, TC Memo 2002-246, aff'd (3d Cir 2004) 382 F3d 367: §§1.33, 1.37A, 4.34

Trade-Mark Cases (1879) 100 US 82, 25 L Ed 550: §8.33B

True, Estate of v Commissioner (10th Cir 2004) 390 F3d 1210: §§1.25, 2.7, 2.9-2.11

Trueman, Estate of v U.S. (Cl Ct 1984) 84-2 USTC ¶13,590, 54 AFTR2d 6514: §3.25

Trust Servs. of Am., Inc., v U.S. (CD Cal 1988) 88-1 USTC ¶13,767, 71A AFTR2d 5002, aff'd in part and rev'd in part on other grounds (9th Cir 1989) 885 F2d 561: §9.28

Turner v Commissioner (3d Cir 2004) 382 F3d 367: §1.37B

U

U.S. v Byrum (1972) 408 US 125, 33 L Ed 2d 238, 92 S Ct 2382: §1.37A

V

Van Camp v Van Camp (1921) 53 CA 17, 199 P 885: §2.12

Venegas Hernandez v Peer Int'l Corp. (D PR 2003) 270 F Supp 2d 207: §8.20

Ventas Finance I, LLC v Franchise Tax Board (2008) 165 CA4th 1207, 81 CR3d 823: §5.14

Virginia A. Bigelow, Estate of, TC Memo 2005-65, aff'd (9th Cir 2007) 503 F3d 955: §§1.37A-1.37C

Virginia Z. Harwood (1984) 82 TC 239, aff'd (9th Cir 1986) 786 F2d 1174 (unpublished opinion): §§1.14, 1.16

W

W.W. Jones II, Estate of (2001) 116 TC 121: §§1.34-1.35

Walter J. Moore, TC Memo 1968-110: §8.18

Walton, Audrey J. (2000) 115 TC 589, acq 2003-2 Cum Bull 964: §2.23

Ward, Charles W. (1986) 87 TC 78: §2.39

Wayne C. Bongard, Estate of (2005) 124 TC 95: §§1.37-1.37B, 4.34, 9.33

Webster E. Kelley, Estate of, TC Memo 2005-235: §1.37C

Wehausen, John V., (1988) TC Memo 1988-460: §7.61

Whalen v U.S. (7th Cir 1987) 826 F2d 668: §3.30

William E. Straw, TC Memo 1991-524: §7.61

William Glen (1982) 79 TC 208: §§7.9, 7.61

Williams, Ellie B., Estate of, TC Memo 1998-59: §4.32

Williamson v Commissioner (9th Cir 1992) 974 F2d 1525: §3.25

Wineman, Rebecca A., Estate of, TC Memo 2000-193: §§3.10, 3.12, 3.37

Winkler, Clara S. Roeder, Estate of, TC Memo 1989-231: §1.21

Winokur, James L. (1988) 90 TC 733, acq 1989-2 Cum Bull 1: §§7.26, 7.61

Woodbury G. Andrews, Estate of (1982) 79 TC 938, superseded by statute on other grounds as stated in Eisenberg v Commissioner (2d Cir 1998) 155 F3d 50: §§1.14-1.16, 1.36

Worth, Marriage of (1987) 195 CA3d 768, 241 CR 135: §8.13

Security and ExchangeCommission No-Action Letters

American Bar Ass'n (May 2, 1991): §9.12B

D'Ancona & Pflaum (Feb. 18, 1992): §9.12B

Goldman, Sachs & Co. (Dec. 20, 1999): §9.46

Luce, Forward, Hamilton & Scripps (May 21, 1992): §9.12A

Manatt, Phelps & Phillips (Aug. 5, 1991): §9.12B

Morgan Stanley & Co. (Nov. 29, 1984): §9.35

Munger, Tolles & Olson (Dec. 10, 1991): §9.26

P. Michael Coleman (Dec. 29, 1994): §9.27

Peter J. Kight (Oct. 16, 1997): §§9.31C-9.31D, 9.60

R.E. Turner & The Turner Found. (Mar. 19, 1993): §9.27

Riordan & McKinzie (May 5, 2000): §9.27

Sarkowsky Found. (Feb. 6, 1990): §9.26

Service Merchandise Co. (Jan. 11, 1988): §§9.27, 9.31C

The Gap, Inc. (Sept. 16, 1992): §9.27

Widett, Slater & Goldman, P.C. (Mar. 25, 1992): §9.33

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/Table of References

Table of References

Advising California Partnerships (3d ed Cal CEB 1999): §§1.6, 1.13, 4.15-4.16, 5.14

Business Buy-Sell Agreements (Cal CEB 1991): §§2.2, 2.4, 2.39, 3.4, 3.15

California Decedent Estate Practice (2d ed Cal CEB 2009): §8.18

California Elder Law Resources, Benefits, and Planning: An Advocate's Guide (Cal CEB 2003): §3.1A

California Estate Planning (Cal CEB 2002): §§1.3, 1.13-1.14, 1.23-1.24, 1.40-1.40A, 1.52, 1.54, 3.68, 4.20, 4.24, 10.10, 10.16, 10.18

California Powers of Attorney and Health Care Directoves (Cal CEB 2008): §§3.5, 6.1, 6.17-6.18

California Trust Administration (2d ed Cal CEB 2001): §6.24

California Trust and Probate Litigation (Cal CEB 1999): §6.32

Counseling California Corporations (3d ed Cal CEB 2008): §1.10

Drafting California Irrevocable Trusts (3d ed Cal CEB 1997): §§1.40A, 2.17, 2.25, 4.18, 4.20-4.21, 7.32, 9.32, 9.44

Drafting California Revocable Trusts (4th ed Cal CEB 2003): §§4.19, 4.37-4.38, 5.22, 6.1, 6.17, 6.32-6.35

Financing and Protecting California Businesses (Cal CEB 2006): §9.32

Forming and Operating California Limited Liability Companies (2d ed Cal CEB 2007): §§1.9, 4.17, 5.14

Huggins Balfe, Judith. Passing It On: The Inheritance and Use of Summer Houses. Susquehanna, Pa., Pocomo Press, 1999: §4.1

Nimmer, David. Nimmer on Copyright. Multivolume. Matthew Bender, 2009: §8.15E

Organizing Corporations in California (3d ed Cal CEB 2001): §1.10

Practice Under the California Family Code: Dissolution, Legal Separation, Nullity (Cal CEB Annual): §2.12

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/Table of Forms

Table of Forms

Charitable contributions of art or other collectibles

Deed of fractional interest, 7.65

Deed of gift of entire interest, 7.63

Deed of gift of entire interest (several item, specific conditions), 7.64

Letter requiring information from charity before contribution, 7.62

Specific gift of work of art, 7.66

Companion animals

Care for companion animals in case of settlor's incapacity, 6.18

Caretaker, appointment of, 6.13

Distribution of residue to charity, 6.28

Distribution of trust residue to companion animal trust, 6.22

Instruction not to separate companion animals, 6.16

Married couples' trust providing for care of companion animals, 6.35

Outright gift in trust agreement, 6.8

Outright gift in will, 6.7

Outright gift to animal protection organization, 6.10

Remainder gift not qualifying for charitable deduction, 6.31

Single settlor's trust with provisions for care of companion animals, 6.34

Specific distribution to companion animal trust, 6.21

Trustee provisions, 6.12

Veterinarian information, 6.26

Law practice, disposition of

Nomination of practice administrator, 11.12

Order appointing practice administrator, 11.9

Petition for appointment of practice administrator, 11.8

Resolving conflicts for corporate trustees in relation to investments, 9.59

Stock options

Beneficiary designation, 10.43

Option transfer, consent, and indemnity agreement, 10.39

Vacation homes

Cotenancy agreement, 4.39

Lake home trust, 4.38

Management procedures, 4.36

Sample trust provisions for vacation home, 4.37

© The Regents of the University of California

Source: Estate Planning/Estate Planning for Special Assets/Index

Index

A B C D E F G H I J K L M N O P Q R S T U V W X Y Z

References are to chapter section numbers

The symbol "" after a section number indicates that a formappears in the section.

Administrators. See Executors and Administrators

Agents and Agency

Partner acting as agent of partnership, 4.15

Agriculture. See Farms, Ranches, and Vineyards

Alternative Minimum Tax (AMT)

Incentive stock options, AMT liability on exercise of, 10.6, 10.44

Amendments and Modifications

Articles of incorporation, amendment of, 2.14

Vacation property, effect of transferor retaining right to amend transfer of, 4.29

AMT. See Alternative Minimum Tax (AMT)

Animals. See Companion Animals or Pets, Estate Planning For

Annual Exclusion. See Gifts and Gift Taxes

Appraisers and Appraisals

See also **Valuation**

Charitable deduction, appraisal of property for purposes of. See **Charitable Contributions**

Experts. See **Experts and Expert Witnesses**

Family business. See **Family Business Entities**

Art and Collectibles

Charitable contributions of. See **Charitable Contributions**

Charitable remainder trust, art held in, 7.31, 7.35A

Copyright, purchasing work of art without transfer of, 7.43

Definitions

Collectibles, 7.1

Fine art, 8.34

Gifts

Copyright interest separate from underlying work of art, 8.20

Ordinary income property, gift from artist retaining character as, 7.12

Remainder interest in artwork, disadvantage of transferring to charitable organization, 7.30

Sale of

Offsetting losses against gains from sales of collectibles, 7.9

Subsequent sales of fine art, California law providing for payment to artist for, 8.34

Valuation. See **Valuation**

Assignment

Copyright, assignment of. See **Copyrights**

Patent, assignment of, 8.29

Attorneys

Advising clients on structure and formation of family business, 1.4, 1.53

Conflict of interest representing multiple clients in family business, 1.4

Law practice. See **Law Practice, Disposition of**

Attorneys' Fees

Practice administrator for solo practitioner, problems involving fees, 11.15

Auction As Method of Determining Asset's Value. See Valuation

Basis

Artworks, basis for purposes of sale, 7.61A

Discount valuation, effect on property's basis, 1.18

Farm property. See **Farms, Ranches, and Vineyards**

Income in respect of decedent, inapplicability of step-up-in-basis rule to, 3.74

Lifetime gifts, carryover basis equal to donor's basis, 3.11, 3.14

Qualified personal residence trust (QPRT), beneficiary receiving carryover basis in property on termination of, 4.22

Restricted or control stock, basis adjustment at stockholder's death, 9.18, 9.42

Bonds. See Surety Bonds

Brokers

Sale of securities, broker's restrictions in, 9.9

Burden of Proof

See also **Proof**

Family business, taxpayer's burden of proving amount of valuation discount for, 1.38

Buy-Sell Agreements

Family business

Generally, 1.25

Succession planning. See **Family Businesses, Succession Planning For**

Farms. See **Farms, Ranches, and Vineyards**

Testamentary device, buy-sell agreement as, 2.7

Bypass Trust

Phase-out of state death tax credit, effect on bypass trust. See **Estate and Inheritance Tax, State**

Special use valuation property, funding bypass trust with, 3.72

Capital Gains and Losses

Charitable contribution of capital gain property. See **Charitable Contributions**

Collectibles, offsetting losses against gains from sales of, 7.9

Discount valuation, effect on property's basis, 1.18

Dissolution of corporation, effect of, 1.11

Holding period for capital gains purposes, 3.65, 3.77

Patents, long term capital gains treatment of, 8.30

Restricted securities, deferral of gain recognition on, 9.16

Stock options. See **Stock Options**

Trade or business, holding period for property used in, 3.77

Cats. See Companion Animals or Pets, Estate Planning For

Celebrity Likeness

Astaire Celebrity Image Protection Act prohibiting use of deceased person's name, voice, or likeness without consent, 8.35

Challenging Validity of Business Entity. See IRS Challenging Validity of Business Entity

Charitable Contributions

Amount of deduction

Estate taxes or other items chargeable against testamentary gift to charity, effect on amount of charitable deduction, 7.42

Private foundation for public charity, amount of deduction for contribution to, 7.7

Related use rule, effect on amount of charitable deduction, 7.34

Animal companion trusts. See **Companion Animals or Pets, Estate Planning For**

Appraisal of property

Generally, 7.19

Appraisal summary, information required on, 7.22

Checklist for qualified appraisal, 7.67

Estate, gift, or income tax deduction, appraisal of tangible personal property for, 7.45

Fee paid to appraiser, restrictions affecting, 7.23

Qualified appraisal, contents of, 7.20

Qualified appraiser, requirements affecting, 7.21

Substantiation requirements for charitable deduction, 7.19

Basis for purposes of sale, 7.61A

Capital gain property

Characterization of donated property, 7.9

Distinction between ordinary income and long-term capital gain, 7.8

General percentage limitation on charitable deduction, 7.14

Characterization of donated property

Generally, 7.8

Capital gain property, 7.9

Ordinary income property (see Ordinary income property, below)

Charts and checklists

Donors, checklist for, 7.25

Qualified appraisal, checklist for, 7.67

Qualified organizations for charitable election, chart, 7.18

Complete inter vivos charitable transfers

Generally, 7.3

Appraisals (see Appraisal of property, above)

Characterization of donated property (see Characterization of donated property, above)

Checklist for donors, 7.25

Deed of gift, charitable organization's formal acceptance of, 7.24

General percentage limitations (see General percentage limitation on charitable deduction, below)

Qualified organizations for income tax deductions, chart, 7.18

Status of organization (see Status of charitable organization, below)

Complete testamentary charitable transfers, 7.42

Copyright, charitable contributions of

American Jobs Creation Act of 2004, computation of charitable income tax deduction for contribution of copyright, 8.31

Gift and estate tax issues involving, 8.20

Income tax issues involving, 8.19

Retained copyright interest by decedent, effect on charitable deduction, 7.43

Separate property interests, copyright and work of art as, 7.43

Deed of gift

Entire interest, 7.63

Entire interest, several items with specific conditions, 7.64

Formal acceptance of deed by charitable organization, 7.24

Fractional interest, 7.65

Foreign tax-exempt organizations, restrictions on charitable deduction for contributions to, 7.1

Fractional gifts, charitable deduction for

Generally, 7.26

Factors to consider in making fractional gifts, 7.29

Future interest rule, effect of partial interest rule on, 7.30

Treatment of fractional gifts under IRC §170(o) (see Treatment of fractional gifts under IRC §170(o), below)

Valuation of fractional interest, 7.27, 7.28A

General percentage limitation on charitable deduction

Capital gain property percentage limitation, 7.14

Carrying forward charitable deduction exceeding applicable percentage limitations, 7.14

Examples of applying percentage limitations to inter vivos charitable transfers, 7.15

IRS letter rulings construing related use rule, 7.17

Ordinary income property percentage limitation, 7.13

Related use rule (see Related use rule, below)

Inter vivos charitable transfers

Complete transfers (see Complete inter vivos charitable transfers, above)

Partial inter vivos charitable transfers (see Partial inter vivos charitable transfers, below)

Letter requiring information from charity before contribution, 7.62

Nonqualified stock options, transfer to charitable organization. See **Stock Options**

Ordinary income property

Defined, 7.10

Distinction between ordinary income and long-term capital gain, 7.8

Gift of art work from artist retaining character as ordinary income property, 7.12

Limit on charitable deduction to 50 percent of taxpayer's contribution base, 7.13

Reduction of charitable deduction, classifying artwork as ordinary income property resulting in, 7.11

Taxidermy property, 7.12A

Works created by artist characterized as, 7.11

Partial interest rule (see Fractional gifts, charitable deduction for, above)

Partial inter vivos charitable transfers

Charitable remainder trust. See **Charitable Remainder Trust**

Fractional gifts (see Fractional gifts, charitable deduction for, above)

Future interest, postponement of charitable deduction for gift of, 7.30

Retained life estate in work of art, effect on charitable deduction, 7.30

Patents, charitable contributions of, 8.31

Pension Protection Act of 2006

Generally, 7.16

Qualified appraisal defined, 7.20

Qualified appraiser defined, 7.21

Treatment of fractional gifts under IRC §170(o) (see Treatment of fractional gifts under IRC §170(o), below)

Private operating foundation, qualifications for

Generally, 7.36

Asset test, 7.38-7.39

Endowment test, direct distributions of at least two-thirds of foundation's minimum investment return of endowment, 7.40

Income test, 7.37

IRS rulings on asset test, private foundation's ownership of art, 7.39

Support test, requirement that private foundation's support come from combination of general public and five or more exempt organizations, 7.41

Qualified conservation easement, charitable deduction for value of, 3.119-3.119A

Related use rule

Generally, 7.16

Copyright interest in work of art, effect of related use rule on, 7.43

Correspondence with charitable organization to establish proof necessary to meet related use rule, 7.24

Fractional gifts under IRC §170(o), use limitation for, 7.28C

IRS letter rulings construing, 7.17

Testamentary transfers, inapplicability of related use rule to, 7.42

Trustee's sale of work of art within first year of trust, effect of related use rule on amount of charitable deduction, 7.34

Restricted securities. See **Restricted Securities**

Special use valuation, gift-over to charity disqualifying property from, 3.28

Specific gift of work of art, 7.66

Status of charitable organization

Eligible donee status, verification of, 7.7

Private or "30/20" organizations, 7.6

Public charities versus private foundations, 7.4, 7.7

Public or "50/30" organizations, qualified organization classified as, 7.5

Statutes governing charitable giving, 7.2

Statutory incentives for individuals to contribute works of art to tax-exempt organizations, 7.1

Testamentary gift to public charity or private foundation, 7.42

Treatment of fractional gifts under IRC §170(o)

Generally, 7.28

Denial of deduction, 7.28E

Estate and gift tax treatment, generally, 7.28F

Planning considerations, 7.28G

Recapture of deduction, 7.28D

Timing limitation, 7.28B

Use limitation, 7.28C

Valuation limitation, 7.28A

Valuation. See **Valuation**

Charitable Remainder Trust

Disadvantages of, 7.32

Net income method charitable remainder unitrust (NIMCRUT), 7.35A

Requirements for charitable deduction if remainder interest passing to charity, 7.31

Sale of non-producing-income property within first year

Generally, 7.32

Advantage of independent trustee over grantor trustee, 7.35

Art sold after first year, 7.35A

IRS letter ruling, 7.33

Related use rule, effect on amount of charitable deduction, 7.34

Treatment of trust as charitable remainder trust, art held for trust term disqualifying trust from, 7.31

Charts, Checklists, Questionnaires, and Tables

Animal companions, checklist for client interview, 6.32

Charitable deductions. See **Charitable Contributions**

Estate tax. See Estate and Inheritance Tax, State**;** Estate Tax, Federal

Gift tax exemptions and rates, 10.11

Restricted securities. See **Restricted Securities**

Stock options. See **Stock Options**

Children. See Parent and Child

Closely Held Businesses

Deferral of estate tax attributable to decedent's closely held business, 2.42

Family business. See **Family Business Entities; Family Businesses, Succession Planning For**

Farms. See **Farms, Ranches, and Vineyards**

IRS challenging validity of. See **IRS Challenging Validity of Business Entity**

Collectibles. See Art and Collectibles

Community Property

Copyrights, effect of community property laws on ownership of, 8.13

Family business, buy-sell agreement for buyout of spouse's community property interest in, 2.12

Gifts of community property, requirements affecting, 10.10

Patents, effect of community property laws on ownership of, 8.29

Split gift by spouses, 10.10

Companion Animals or Pets, Estate Planning For

Generally, 6.1

Alternatives to companion animal trust (see Outright gifts as alternative to trust, below)

Caretaker (see Trustee and caretaker, roles of, below)

Charities

Restrictions on charitable deduction for animal companion trust providing for remainder going to charity, 6.30, 6.31

Termination of companion animal trust, distribution of residue to charity after, 6.28

Checklist for client interview, 6.32

Deductions (see Tax issues, drafting considerations for, below)

Distributions

Funding trust (see Funding companion animal trust, below)

Income tax deduction for distributions prohibited, 6.29

Termination of trust, distribution on (see Termination of companion animal trust, below)

Drafting companion animal trust provisions

Cost of custom drafting trust, advising client of, 6.5

Expenses for care of companion animal, 6.23

Funding trust (see Funding companion animal trust, below)

Incapacity of settlor (see Incapacity of settlor, trust provisions for, below)

Specific companion animals (see Specific companion animals, providing for, below)

Tax issues (see Tax issues, drafting considerations for, below)

Termination of trust (see Termination of companion animal trust, below)

Trustee and caretaker (see Trustee and caretaker, roles of, below)

Veterinarian information, 6.25, 6.26

Funding companion animal trust

Generally, 6.20

Incapacity of settlor, funding trust on, 6.19

Specific distribution to companion animal trust, 6.21

Trust residue, distribution to companion animal trust, 6.22

Will used to fund testamentary companion animal trust, 6.3

Incapacity of settlor, trust provisions for

Generally, 6.17

Care of companion animals in case of settlor's incapacity, 6.18

Funding trust on settlor's incapacity, 6.19

Outright gifts as alternative to trust

Animal protection organization, outright gift to, 6.9, 6.10

Person agreeing to care for animal, outright gift of animal and funds to, 6.6

Trust agreement, outright gift in, 6.8

Will, outright gift in, 6.7

Specific companion animals, providing for

Generally, 6.14

Instruction not to separate companion animals, 6.15, 6.16

Instructions for care of specific companion animals, 6.15

Tax issues, drafting considerations for

Charitable deduction, denial of, 6.30, 6.31

Distributions, no deductions for, 6.29

Income tax consequences, 6.29

Termination of companion animal trust

Charity, distribution of residue to, 6.28

Death of animal, termination of trust on, 6.2A

Remainder beneficiary, designation of, 6.27

Trustee and caretaker, roles of

Generally, 6.11

Appointment of caretaker, 6.13

Fees for caretaker and trustee, 6.4A, 6.24

Trustee provisions, 6.12

Trust providing for companion animals

Advantages of using trust to provide for companion animal, 6.3

Alternatives to companion animal trust (see Outright gifts as alternative to trust, above)

Assets to fund companion animal trust, 6.4

Distribution requirements, 6.2A

Drafting companion animal trust provisions (see Drafting companion animal trust provisions, above)

Enforcement and reporting requirements, 6.2B

Enforcement of trust, problems involving, 6.3

Married couples' trust providing for care of companion animals, 6.35

Single settlor's trust with provisions for care of companion animals, 6.34

Statutory authority for, 6.2

Trustee duties and fees, 6.4A

Wills

Beneficiary, prohibition against animal as, 6.2

Outright gift in will as alternative to trust, 6.7

Trust agreement for companion animal, will used to fund, 6.3

Compensation. See Salaries and Compensation

Compensatory Stock Options. See Stock Options

Conflict of Interest

Companion animal, conflict of interest in trustee serving as caretaker for, 6.11

Family business, conflict of interest in representing multiple clients, 1.4

Investments, resolving conflicts for corporate trustees in relation to, 9.59

Consent

Astaire Celebrity Image Protection Act prohibiting use of deceased person's name, voice, or likeness without consent, 8.35

Gifts of community property, spouse's consent to, 10.10

Special use valuation, agreement between interested parties consenting to recapture provisions of IRS Code, 3.54

Conservation Easements

Farms. See **Farms, Ranches, and Vineyards**

Vacation property, conservation easement for. See **Vacation Homes, Estate Planning For**

Conservatorships. See Law Practice, Disposition of

Consideration

Buy-sell agreement fixing value for estate tax purposes, transferring property to family members for less than full and adequate consideration prohibited, 2.7

Transfer of nonqualified stock option to family member without consideration, imposition of gift taxes on fair market value of stock option, 10.12

Constitutional Law

Copyrights, constitutionality of statute extending terms of, 8.3

Patents, constitutional basis for, 8.25

Construction and Interpretation

See also **Definitions**

Net income method charitable remainder unitrust (NIMCRUT), 7.35A

Related use ruling, IRS letter rulings construing, 7.17

Contracts

Buy-sell agreements. See **Buy-Sell Agreements**

Consideration. See **Consideration**

Derivative contract, 9.37

Control, Discount For Lack of. See Discounts

Control Stock. See Restricted Securities

Copyrights

Generally, 8.1

Assignment of copyright

Generally, 8.12

Termination of transfer of copyright rights, 8.16-8.16C

Community property laws, effect on copyright ownership, 8.13

Constitutionality of statute extending terms of copyrights, 8.3

Duration of copyright

Generally, 8.1, 8.9

January 1, 1978, duration of copyright for works created or published on or after, 8.11, 8.16B

Pre-1978 works, 8.10

Works for hire, duration of, 8.11

History of copyright law

English copyright law, 8.2

International copyrights, 8.4

U.S. copyright law, 8.3

License

Distinguishing assignment from exclusive license to exploit copyrighted work, 8.12

Income in respect of decedent, 8.18

Protection offered by copyright

Original works of authorship, 8.5

Rights protected in original works, 8.6

Renewal of copyright

Generally, 8.14-8.15

Extended renewal term claims for pre-1978 transfers (17 USC §304(c)), 8.15A-8.15E

First term on January 1, 1978 (§304(a)), 8.15F

Pre-1978 works, 8.10

Right to renewal term, valuation separately from copyright, 8.22

Surviving spouse, Termination rights, 8.16A

Tax issues

Charitable contributions of copyright. See **Charitable Contributions**

Gift and estate tax issues, 8.20, 8.22

Income in respect of decedent, 8.18

Income tax on proceeds from sale of copyright, 8.18

Liquidity problems as result of including copyright interests in estate, 8.23

Marital deduction issues, 8.21

Valuation of copyrights for gift and estate tax purposes, 8.22

Termination rights

Generally, 8.14, 8.16

Exercising termination rights, 8.17

"Otherwise than by will" exception, 8.16C

Persons who may terminate, 8.16A

Right to terminate, valuation separately from copyright, 8.22

Time considerations, 8.16B

Transfer of copyright ownership (see Assignment of copyright, above)

Types of copyrights

Individual authors, copyright vesting in, 8.7

Works for hire (see Works for hire, below)

Work of art, purchase without transfer of copyright, 7.43

Works for hire

Generally, 8.8

Duration of, 8.11

Corporations

See also **Shares and Shareholders**

Generally, 1.10

Dividends. See **Dividends**

Family business entity, using corporation as. See **Family Business Entities**

Family business, succession planning for. See **Family Businesses, Succession Planning For**

Farms. See **Farms, Ranches, and Vineyards**

S corporations. See **S Corporations**

Costs

See also **Expenses and Expenditures; Fees**

Companion animal trust, advising client of cost of drafting, 6.5

Cotenants. See Tenancy in Common

Criminal Law

Valuation of stolen property, 7.59

Crops. See Farms, Ranches, and Vineyards

Debts

Limited liability company (LLC), nonliability of member for debts of, 4.17

Deductions

Animal companion trust, deductions for distributions. See **Companion Animals or Pets, Estate Planning For**

Charitable deductions. See **Charitable Contributions**

Conservation easement, income tax deduction for, 4.24

Marital deduction. See **Marital Deduction**

Unified credit and deduction for state death taxes, 5.10

Vacation homes, tax deductions affecting. See **Vacation Homes, Estate Planning For**

Deeds. See Charitable Contributions

Definitions

See also **Construction and Interpretation**

Adjusted tax difference, 3.57

Affiliates, 9.5

Animal, 6.2

Applicable retained interest, 1.23

Blockage discount, 7.51

Buddy agreements, 11.1, 11.11

Call option, 9.37

Capital asset, 7.12

Caretaker of companion animal, 6.11

Cashless, 9.37, 9.40

Change of ownership (real property), 4.35

Collectibles, 7.1

Collectibles gain, 7.9

Conservation purpose, 3.119, 4.24

Contribution base, 3.119A, 7.13

Control persons, 9.5

Control stock, 9.5

Copyrights, 8.1

Counterparty, 9.37

Decoupling (state and federal estate taxes), 5.3

Derivative, 9.37

Derivative contract, 9.37

Development rights, 3.120

Electing small business trust (ESBT), 2.36

Eligible qualified heir, 3.60

Estate taxes, 1.14

Fair market value, 1.14, 3.18, 4.31, 7.45

Family member, 2.5, 10.19

Farm, 3.23

Fine art, 8.34

Flip unitrust, 7.35A

Gift taxes, 1.14

Grantor retained annuity trust (GRAT), 2.17

Grantor trust, 2.26, 2.32

Immediate family, 9.29

Incentive stock option (ISO), 10.3

Includable farm rental income, 3.42

Income in respect of decedent, 3.74

Interest in closely held business, 2.42, 3.82

Letter stock, 9.5

Limited liability company, 1.9

Limited partnership, 4.16

Livestock, 3.78

Member of family, 3.21

Midstream incorporation of farm, 3.118

Monetize, 9.37

Nonqualified stock option (NQSO), 10.3

Nonvested stock, 9.17

Off-farm heirs, 3.4

On-farm heirs, 3.4

Ordinary income property, 7.10

Partnership, 1.6, 4.14

Patent, 8.29

Patents, 8.1

Person, 6.2

Pick-up tax, 5.3

Premium, 9.37

Present interest in property, 10.10

Private foundations, 7.4

Property, 3.111

Property located in California, 5.5

Public charities, 7.4

Put option, 9.38

Qualified appraisal, 7.20

Qualified appraiser, 7.21

Qualified conservation easement, 3.119, 4.25

Qualified farmer or rancher, 3.119A

Qualified organization, 7.43

Qualified payment right, 1.23

Qualified personal residence trust (QPRT), 4.20

Qualified real property interest, 3.119

Qualified subchapter S trust (QSST), 2.33

Qualified woodland, 3.23

Restricted stock, 9.5

Settlement, 9.37

Split gift by spouses, 10.10

Sponge tax, 5.3

Stock option, 10.2

Tangible personal property, 7.16

Taxable estate (estate tax), 10.16

Taxable gifts, 10.10

Trademark or service mark, 8.33A

United States, 3.20

Work for hire, 8.8

Work of art, 7.43

Works of authorship, 8.5

Zeroed-out GRAT, 9.44

Disabled Persons

Decline in stock values, increase in disability insurance as hedge against, 9.48

Farm, special use valuation rules applicable to disabled owner of, 3.38

Law practice of disabled solo practitioner, planning for disposition of. See **Law Practice, Disposition of**

Stock option, expiration on employee's disability, 10.2

Disclaimer

Incapacitated farmer, attorney-in-fact under durable power of attorney disclaiming property on behalf of, 3.5

Qualified heir, effect of nonqualifying heir executing disclaimer allowing property to pass to, 3.27

Surviving spouse, disclaimer by, 5.22

Disclosures

Circular 230, recommended disclosure to avoid problems under, 1.40A

Restricted securities, disclosing gift of, 9.29

Rule 144 of Securities Act, disclosure of sale orders required by, 9.5

Discounts

Blockage discount, 7.51

Control, discount for lack of

Family businesses, 1.16

Vacation homes, 4.32

Family businesses. See **Family Business Entities**

Farm land, discounts for. See **Farms, Ranches, and Vineyards**

Marketability, discount for lack of

Family businesses, 1.15

Vacation homes, 4.33

Partnership interests, valuation discounts for transfer of, 4.15

Vacation property. See **Vacation Homes, Estate Planning For**

Dissolution of Marriage, Transfer of Stock Options After. See Stock Options

Distributions

Companion animal trust, distributions to. See **Companion Animals or Pets, Estate Planning For**

Dividends. See **Dividends**

Farms. See **Farms, Ranches, and Vineyards**

Qualified subchapter S trust (QSST), income distribution requirement for, 2.34

Redemption of stock to pay estate tax, distribution made in, 2.41

Restricted and control securities, special provisions dealing with distribution of, 9.57

Dividends

Redemption of stock to pay estate tax not constituting dividend, 2.41

Retained earnings of corporation, distribution treated as taxable dividend, 3.6

Stock options, determining factor for expected dividends on underlying stock, 10.27

Dogs. See Companion Animals or Pets, Estate Planning For

Durable Power of Attorney

Farm, advantages of durable powers of attorney in planning estate containing, 3.5

Easements. See Conservation Easements

Electing Small Business Trust (ESBT). See Family Businesses, Succession Planning For

Employers and Employees. See Stock Options

Encumbrances. See Liens and Encumbrances

Estate and Inheritance Tax, State

See also **Estate Tax, Federal**

Generally, 5.1, 5.3

California domiciliary owning out-of-state property in decoupled state

Generally, 5.11

Gift of property before death, 5.13

Limited partnership or limited liability company (LLC), contributing out-of-state property to, 5.14

Married persons (see Married persons, planning issues for, below)

Selling out-of-state property, advantages and disadvantages of, 5.12

Charts and tables (see Decoupling of state estate tax from federal estate tax, below)

Death tax credit (state)

California's pick-up tax, effect of phase-out on, 5.5

Phase-out of, 5.2, 5.5, 5.24

Unified credit and deduction for state death taxes, 5.10

Decoupling of state estate tax from federal estate tax

Generally, 5.6

Chart, estate tax rates after phase-out of state tax credit, 5.8

Decedent dying in decoupled state in 2008, tax rate on estate, 5.7

Definition of decoupling, 5.3

Hypothetical example, 5.9

Out-of-state property owned by California domiciliary (see California domiciliary owning out-of-state property in decoupled state, above)

State death tax credit, decoupled estates after phase-out of, 5.8

Table, status of states regarding decoupling, 5.26

Tax rate in decoupled states, 5.4

Married persons, planning issues for

Generally, 5.15

Disclaimer by surviving spouse, 5.22

Funding bypass trust with lesser of federal or state exclusion amounts, 5.21

Marital deduction, qualifying additional property for, 5.18

Payment of state death tax by surviving spouse, 5.23

Planning options for spouses, 5.17-5.23

QTIP trust (see Qualified terminable interest property (QTIP) trust, below)

Qualified terminable interest property (QTIP) trust

Clayton QTIP trust, effect of, 5.20

State QTIP trust as means of avoiding state death taxes, 5.19

Rates for estate tax, effect of phase-out on, 5.4

Spouses (see Married persons, planning issues for, above)

State estate taxes

Decoupling (see Decoupling of state estate tax from federal estate tax, above)

Pick-up tax, elimination of, 5.3

Surviving spouse (see Married persons, planning issues for, above)

Tax apportionment clause for out-of-state property, 5.25

Estate Tax, Federal

See also **Estate and Inheritance Tax, State**

Charitable contributions. See **Charitable Contributions**

Conservation easements, 4.25

Copyright, estate tax issues involving, 8.20, 8.22

Definition of estate tax, 1.14

Family businesses. See Family Business Entities**;** Family Businesses, Succession Planning For

Farms. See **Farms, Ranches, and Vineyards**

Freezing value of property for estate tax purposes. See **Valuation**

Generation-skipping transfers. See **Generation-Skipping Transfers (GSTs)**

Grantor retained annuity trust (GRAT), estate tax considerations, 2.20

Installment payment of estate tax. See **Farms, Ranches, and Vineyards**

Lien on decedent's property to secure payment of, 3.62, 3.99

Patents, estate tax issues involving, 8.32

Phase-out of state death tax credits. See **Estate and Inheritance Tax, State**

Restricted securities, estate tax deferral for shareholder of publicly-traded corporation, 9.19

Stock options. See **Stock Options**

Tables

Exemption amount and rates, 10.17

Phase-out of state tax credit, estate tax rates after, 5.8

Valuation. See **Valuation**

Estate Tax Inclusion Period (ETIP)

Qualified personal residence trust (QPRT), end of ETIP after termination of, 4.22

Ethics. See Conflict of Interest

Executors and Administrators

Installment payment of estate tax. See **Farms, Ranches, and Vineyards**

Practice administrator for solo practitioner. See **Law Practice, Disposition of**

Restricted securities, postdeath administration of. See **Restricted Securities**

Expenses and Expenditures

See also **Costs; Fees**

Companion animal trust providing for payment of expenses for care of companion animal, 6.23

Farming property, expenses of administering estate containing. See **Farms, Ranches, and Vineyards**

Funeral expenses, redemption of IRC §303 stock to pay, 2.41, 3.107

Experts and Expert Witnesses

Appraisal

Art collection, 7.52

Family business, court's rejection of expert's appraisal of, 1.39

Extension of Time

Copyright renewal, extension of, 8.15A-8.15E

Patent, extension of, 8.28

Fair Market Value. See Valuation

Family Business Entities

See also **Family Limited Partnership**

Generally, 1.1

Annual exclusion, gift of interest in family business qualifying for, 1.3

Appraisals

Contents of appraisal, 1.39

Gift tax return, adequate disclosure requirement for, 1.40

Valuation discount, taxpayer hiring qualified appraiser to prove amount of, 1.38

Business purpose for family business entity

Generally, 1.42

Asset protection, family business entity providing, 1.49

Centralized management and control of business assets, 1.43

Charging order, effect of, 1.49

Family investment vehicle, family business entity serving as, 1.47

Family values and bonding between family members, family business reinforcing, 1.46

Investment training for younger generation, family business providing, 1.45

Liability of owners and managers of family business, limits on, 1.48

Pooling of assets for investment, 1.44

California law

Documentary transfer tax, 1.52

Liquidation rights, restrictions on, 1.50

Property taxes, consequences of transferring real property to family business entity on, 1.52

Transfers, restrictions on, 1.51

Choice of entity and formation issues

Generally, 1.5

Choosing investment assets for family business entity, 1.13

Corporations (see Corporations, below)

Limited liability companies (see Limited liability companies (LLCs), below)

Limited partnerships (see Limited partnerships, below)

Conflict of interest in representing multiple clients, 1.4

Corporations

Generally, 1.10

Family limited partnership or family limited liability company versus corporation, 1.11

Discounts in valuation

Generally, 1.14

Burden of proof on taxpayer to prove amount of discount, 1.38

Capital gains tax consequences, effect of valuation discount on basis of property, 1.18

Control, discount for lack of, 1.16

Fair market value of minority or noncontrolling interest in closely held entity, 1.14

IRC Chapter 14 valuation rules (see IRC Chapter 14 valuation rules, below)

Liquidation rights, effect of restrictions on, 1.50

Marketability, discount for lack of, 1.15

Mathematics of discount, 1.17

Estate and gift taxes

Appraisals (see Appraisals, above)

Buy-sell agreement between family members, requirements for, 1.25

Discounts (see Discounts in valuation, above)

IRC Chapter 14 valuation rules (see IRC Chapter 14 valuation rules, below)

Step-transaction doctrine, applicability to gifts of partnership interests, 1.37D

Valuation premiums (see Valuation premiums, below)

Examples of situations using family business entities, 1.3

Fair market value for estate and gift tax purposes (see Estate and gift taxes, above)

Family limited partnerships (see Limited partnerships, below)

Gift taxes (see Estate and gift taxes, above)

IRC Chapter 14 valuation rules

Generally, 1.22

Aggregating voting power held by all family members, IRS position on, 1.36

Court responses to IRS attacks on valuation discounts, 1.31-1.36

Dissolution of limited partnership, 1.29

Economic substance, IRS position that family limited partnership lacks, 1.33

IRC §2036(a), litigation using (see IRC §2036(a), IRS litigation using, above)

IRC §2701, effect on applicable retained interests, 1.23

IRC §2702, elimination of grantor retained income trust (GRIT) among family members, 1.24

IRC §2703, effect on right to acquire or use property at less than fair market value or restrictions on right to sell or use property, 1.25, 1.34

IRC §2704, treatment of lapsed voting or liquidation rights, 1.26-1.29

IRS attacks on valuation discounts, 1.30

Lost value argument, court's rejection of, 1.35

Restrictions affecting limited partners, 1.32

IRS challenging validity of. See **IRS Challenging Validity of Business Entity**

Limited liability companies (LLCs)

Generally, 1.9

Corporation versus family LLC, 1.11

Documentary transfer tax, LLC's exemption from, 1.52

Family limited partnership versus family limited liability company, 1.12

Financial purpose requirement, 1.13

Other estate planning techniques, combining family LLC with, 1.54

Popularity as family business entities, 1.2

Transfer of real property to LLC, reassessment not triggered by, 1.52

Limited partnerships

Generally, 1.6

Corporation versus family limited partnership, 1.11

Documentary transfer tax, limited partnership's exemption from, 1.52

Family limited liability company versus family limited partnership, 1.12

Financial purpose requirement, 1.13

General partner, choice of, 1.7

IRC chapter 14 valuation rules (see IRC Chapter 14 valuation rules, above)

Other estate planning techniques, combining family limited partnership with, 1.54

Popularity as family business entity, 1.2

Transfer of real property to limited partnership, reassessment not triggered by, 1.52

Two or more persons, requirement of, 1.8

Liquidation

California law, restrictions on liquidation rights under, 1.50

IRC §2704, treatment of liquidation rights under, 1.26-1.29

Structuring and forming family business entity

Generally, 1.41

Attorney's skill and expertise, 1.4, 1.53

Business purpose (see Business purpose for family business entity, above)

California law (see California law, above)

Limited liability company (LLC), 4.17

Other estate planning techniques, combining family business entity formation with, 1.54

Partnerships, 4.14-4.16

Qualified personal residence trust (QPRT), 4.20-4.22

Tenancy in common, 4.11-4.13

Trusts, 4.18-4.19

Succession planning for family businesses. See **Family Businesses, Succession Planning For**

Taxes

Encumbered assets, tax consequences of contributing to family business, 1.13

Estate and gift taxes (see Estate and gift taxes, above)

Trademarks, estate planning issues involving. See **Trademarks or Service Marks**

Valuation

Discounts (see Discounts in valuation, above)

IRC Chapter 14 valuation rules (see IRC Chapter 14 valuation rules, above)

Valuation premiums

Generally, 1.19

Control premium, 1.20

Swing vote premium, 1.21

Family Businesses, Succession Planning For

Generally, 2.1

Buy-sell agreements

Generally, 2.2, 3.5

Disadvantages of, 3.16

Estate tax value (see Estate tax, buy-sell agreement fixing value of business for purposes of, below)

First refusal, minority owner's right of, 2.3

Funding buy-out, evaluating methods of, 2.4

Marital property, buy-sell agreement allocating, 2.12

Corporate recapitalization creating voting and nonvoting common stock

Generally, 2.13

Amending articles of incorporation, 2.14

Transfer of nonvoting common stock by majority shareholder to company, 2.15

Electing small business trust (ESBT)

Generally, 2.36

Termination of ESBT, 2.38

Trustee, ESBT election made by, 2.37

Estate tax, buy-sell agreement fixing value of business for purposes of

Generally, 2.5

Arm's-length transactions, terms of agreement comparable to similar agreements entered into by persons in, 2.8

Bona fide business arrangement, requirement that agreement constitute, 2.6

Consideration, transferring property to family members for less than full consideration prohibited, 2.7

Fixed or calculable selling price, 2.11

Lifetime restrictions on agreement price, 2.9

Obligation of decedent's estate to sell business interest at price fixed by agreement, 2.10

Estate tax, payment of

Generally, 2.40

Deferral of estate tax attributable to decedent's closely held business, 2.42

Distribution made in redemption of stock to pay estate tax, 2.41

Gift taxes

Grantor retained annuity trust (GRAT), gift tax considerations involving, 2.19

Installment sale of business to grantor trust, 2.28

Valuation of gifts for federal gift tax purposes, 2.39

Grantor retained annuity trust (GRAT)

Generally, 2.17-2.18

Estate tax considerations, 2.20

Generation-skipping transfer tax considerations, 2.22

Gift tax considerations, 2.19

Income tax purposes, treating GRAT as grantor trust for, 2.21

Installment sale to grantor trust (see Installment sale of business to grantor trust, below)

Practical considerations in using, 2.24

Zeroed-out GRATs, 2.23

Grantor trust

Installment sales (see Installment sale of business to grantor trust, below)

Qualified subchapter S trust (QSST) treated as, 2.35

S corporation shareholder, grantor trust as, 2.32

Income taxes

Grantor retained annuity trust (GRAT) treated as grantor trust for purposes of, 2.21

Installment sale of business to grantor trust, 2.26-2.27

Qualified subchapter S trust (QSST), income distribution requirement for, 2.34

Installment payment of estate taxes, 2.42

Installment sale of business to grantor trust

Generally, 2.25

Combining sale to grantor trust with GRAT, 2.30

Comparison between grantor retained annuity trust (GRAT) and sale to grantor trust, 2.29

Definition of grantor trust, 2.26

Gift tax considerations, 2.28

Income tax considerations, 2.26-2.27

Lifetime transfer strategies

Generally, 2.16

GRAT (see Grantor retained annuity trust (GRAT), above)

Installment sales (see Installment sale of business to grantor trust, above)

S corporations (see S corporation interests, transfer to trust, below)

Valuation of gifts for federal gift tax purposes, 2.39

Qualified subchapter S trust (QSST)

Generally, 2.33

Comparison between QSST and electing small business trust (ESBT), 2.36

Grantor trust, QSST treated as, 2.35

Income distribution requirement for, 2.34

S corporation interests, transfer to trust

Generally, 2.31

Electing small business trust (see Electing small business trust (ESBT), above)

Grantor trust as S corporation shareholder, 2.32

Qualified subchapter S trust (see Qualified subchapter S trust (QSST), above)

Family Limited Partnership

See also **Family Business Entities; Limited Partnerships**

IRS challenging validity of. See **IRS Challenging Validity of Business Entity**

Nonqualified stock option, transfer to family limited partnership, 10.32

Family Members. See Relatives

Family Partnerships

Farm, balancing tax efficiency with retention of control by using family partnership for, 3.13

Famous Persons. See Celebrity Likeness

Farms, Ranches, and Vineyards

Generally, 3.1-3.1A

Acceleration of estate tax (see Installment payment of estate taxes, below)

Adjusted value (see Percentage tests and adjusted value for special use valuation, below)

Basis of property

Gifts, basis of, 3.11, 3.14

Income in respect of decedent, carryover basis from decedent for, 3.74

Income tax on sold farm property, basis for, 3.64

Recapture tax, election for basis increase after imposition of, 3.67

Special use property, basis of, 3.63

Stock not included in decedent's estate, basis of, 3.113

Buy-sell agreements

Generally, 2.2, 3.15

Disadvantages of, 3.16

Funding buy-out, evaluation methods of, 2.4

Shifting ownership interest between heirs, use of buy-sell agreement for, 3.4

Conservation easements

Charitable deduction for value of, 3.119-3.119A

Exclusion of value of underlying land from gross estate, 3.120

Recapture of special use valuation, granting of conservation easement not disposition subjecting qualified heirs to, 3.59

Discount in valuation

QTIP trust, effect of minority interest held by, 3.10

Qualified use property, applicability of discounts to, 3.32

Distributions

Dividend, distribution of stock to shareholder as disguised, 3.112

Executor's duties concerning undistributed net income of estate, 3.97

Management, control, and distribution issues, 3.4

Easements (see Conservation easements, above)

Electing special use valuation

Contents of notice of election, 3.51

Filing election with estate tax return, 3.50

Partial election, 3.52

Protective election to specially value qualified real property, 3.53

Estate tax considerations

Generally, 3.7

Buy-sell agreements (see Buy-sell agreements, above)

Continuance of farming operations after death or incapacity of present generation, 3.9

Deferral of estate tax (see Installment payment of estate taxes, below)

Discontinuance of farming operations after death or incapacity of present generation, 3.8

First spouse to die, circumstances warranting payment of estate tax on death of, 3.10

Installment payment of estate taxes (see Installment payment of estate taxes, below)

Lifetime gifting program (see Lifetime gifting program, below)

Proration of estate taxes, 3.69

Redemption of stock (see Redemption of IRC §303 stock to pay death taxes and administration expenses, below)

Executors (see Installment payment of estate taxes, below)

Expenses of administering estate (see Redemption of IRC §303 stock to pay death taxes and administration expenses, below)

Forfeiture of special use valuation (see Recapture of special use valuation with interest, below)

Generation-skipping transfer taxes

Generally, 3.68

Installment payment of, 3.100

Redemption of stock subject to generation-skipping transfer, 3.116

Special use valuation, applicability to GST taxes, 3.19

Gifts (see Lifetime gifting program, below)

Growing crops, basis of, 3.14

Income in respect of decedent (IRD) farmer

Generally, 3.74

Definition of livestock, 3.78

Holding period of farm assets for capital gains purposes, 3.77-3.79

Items of IRD for farmer under different lease agreements, 3.75

Race horses, 3.79

Transfer of item of IRD, immediate taxation of transferor as result of, 3.76

Installment payment of estate taxes

Active trade or business, determination of, 3.83-3.84

Bond for unpaid taxes, IRS requesting executor to post, 3.99

Closely held business, interest in, 3.82-3.88

Deficiency, filing for election after assessment of, 3.93

Disposition of interest in closely held business, acceleration of tax due, 3.94-3.96

Exceptions to acceleration rule, redemption of stock, reorganization, disposition on death of transferor, 3.95

Failure to make payment of principal or interest, acceleration of tax as result of, 3.98

Family attribution rules, 3.85, 3.87

Filing election for installment payments, 3.91-3.93

14-year deferral, 3.80

Generation-skipping transfer taxes, installment payment of, 3.100

Holding company, disposition of stock in, 3.96

Interest on delinquent payments, 3.90

Lien on estate property as security for unpaid estate taxes, 3.99

Maximum amount of tax payable in installments, 3.89

Partners and shareholders, determination of, 3.85

Passive asset, stock held in another company as, 3.88

Protective election, effect of making, 3.92

QTIP or QDOT property, 3.103

Recapture event triggering acceleration of installment payments, 3.101

S corporations stock, estate's eligibility as shareholder for installment payment period, 3.104

3 years within death rule, effect of, 3.102

Time for making election, 3.91

Timing of installment payments, 3.90

Two or more closely held businesses, adding up interests in, 3.86-3.87

Two percent interest rate, 3.81, 3.88

Undistributed net income of estate, executor's duties concerning, 3.97

Interest on money

Installment payment of estate tax (see Installment payment of estate taxes, above)

Recapture tax (see Recapture of special use valuation with interest, below)

Leases

Gross estate, effect of retaining rights under lease agreement on inclusion of gifted property in, 3.12

Income in respect of decedent under different lease agreements, 3.75

Long-term leases between farm partnership and family members, 3.4

Material participation by decedent or family member, effect of leasing property to partnership or corporation on establishing, 3.47

Qualified use of property, issues involving leases, 3.24

Lifetime gifting program

Generally, 3.11

Advantages and disadvantages of, 3.14

Basis of gifts, 3.11, 3.14

Practical problems involving lifetime gifts of farm assets, 3.12

Trusts, family corporations, or family partnerships, balancing tax efficiency with retention of control by using, 3.13

Marital deduction planning for special use valuation

Generally, 3.70

Funding bypass trust, 3.72

Funding marital share, 3.71

Material participation by decedent or member of family as requirement for special use valuation

Generally, 3.39

Agent, establishing material participation despite use of, 3.45

Crop share versus cash rent, 3.43

Elements of material participation, 3.41

Entity, effect of real property owned by, 3.46-3.49

Estate's ownership of property, effect of, 3.49

Farmer's tax guide (IRS Publication 225) as guidelines, 3.44

Includable farm rental income, 3.42-3.44

Partnership or corporation, effect of leasing real property to, 3.47

Recapture of special use valuation tax, failure to meet material participation rule resulting in, 3.60

Surviving spouse, active management rule for, 3.40

Trust's ownership of real property, effect of, 3.48

Nontax considerations

Generally, 3.2

Business plan, attorney advising client to develop, 3.3

Durable powers of attorney, advantages of, 3.5

Liquidity issues, 3.6

Management, control, and distribution issues, 3.4

Notice of special use valuation (see Electing special use valuation, above)

Percentage tests and adjusted value for special use valuation

Generally, 3.30

Definition of comparable real property, 3.36

Determination of adjusted value, 3.31

Discounts in valuation, applicability of, 3.32

Farm method or capitalization of rents method for determining special use value, 3.35

Five-factor method of determining special value use, 3.37

Methods for determining special use value, 3.34-3.37

Sale of residence, effect of percentage tests on, 3.66

3 years of death, inclusion of property transferred by decedent for purposes of percentage tests, 3.33, 3.102

Qualified conservation easements (see Conservation easements, above)

Qualified heir, acquisition from or passing from decedent to

Acquisition of property from decedent, 3.26

Amount of recapture, 3.57

Passing of property to qualified heir, 3.27

Powers of appointment, effect of exercising in favor of nonfamily member on property's eligibility for special use valuation, 3.29

Successive interests vesting in qualified heir, requirement of, 3.28

Qualified terminable interest property (QTIP)

Inclusion of farm in QTIP trust, 3.10

Installment payment of estate tax on QTIP property, 3.103

Qualified use of property as farm, requirement for special use valuation

At-risk requirement, decedent or member of decedent's family meeting, 3.25

Definition of farm, 3.23

Definition of qualified use, 3.22

Duration of qualified use, 5 out of 8 years as standard for, 3.38

Leases, issues involving, 3.24

Net cash rental to unrelated party as cessation of qualified use, 3.60

Recapture of special use tax on cessation of qualified use, 3.60

Recapture of special use valuation with interest

Generally, 3.54

Acceleration of installment payments of estate tax, recapture event triggering, 3.101

Agreement between interested parties consenting to recapture provision of IRS Code, 3.55

Basis increase if recapture tax imposed, 3.67

Cessation of qualified use as grounds for recapture, 3.60

Disposition of qualified interest as grounds for recapture, 3.59

Grounds for recapture of tax, 3.58-3.60

Liability for recapture tax, 3.61

Material participation rule, effect of failure to meet, 3.60

Payment of recapture tax, time for, 3.57

Person responsible for payment of recapture tax, 3.101

10 years from date of decedent's death, requirement that qualified heir continue to use real property for qualified use for, 3.56

Redemption of IRC §303 stock to pay death taxes and administration expenses

Generally, 2.41, 3.105

Aggregating stock to meet 35-percent test, 3.106

Definition of property, 3.111

Distribution of stock to shareholder as disguised dividend, 3.112

Generation-skipping transfer, redemption of stock subject to, 3.116

Midstream incorporation of farm, 3.118

Obligation of shareholder to pay taxes as requirement for qualified redemption, 3.108

Planning for, 3.117

Property subject to redemption, 3.110-3.114

Specific taxes and expenses of administration, redemption stock to pay, 3.107

Stock included in decedent's estate but held by another person, 3.114

Stock not included in decedent's estate, redemption of, 3.113

3-year inclusion rule, effect of, 3.115

Time period after decedent's death to accomplish redemption, 3.109

Redemption of stock not triggering acceleration of deferred estate taxes, 3.95

Rent

Crop share lease, amount of rent under, 3.24

Farm rental income, 3.42-3.44

Qualified use, net cash rental to unrelated party as cessation of, 3.60

Special use value, farm method or capitalization of rents method for determining, 3.35

Shares of stock

Basis of stock not included in decedent's estate, 3.113

Installment payment of estate taxes (see Installment payment of estate taxes, above)

Redemption of stock (see Redemption of IRC §303 stock to pay death taxes and administration expenses, above)

Special use valuation

Generally, 3.17

Advantages and disadvantages of, 3.73

Basis of special use property, 3.63

Election (see Electing special use valuation, above)

Historical background of valuation reduction, 3.18

Lien for taxes, 3.62

Marital deduction planning (see Marital deduction planning for special use valuation, above)

Material participation (see Material participation by decedent or member of family as requirement for special use valuation, above)

Maximum inflation indexed amount, reduction from fair market value to special use value not exceeding, 3.19

Member of family, use of property restricted to, 3.21

Percentage tests and adjusted value (see Percentage tests and adjusted value for special use valuation, above)

Persons with interest in qualified real property consenting to personal liability for estate tax as requirement for special valuation, 3.7

Qualified heir (see Qualified heir, acquisition from or passing from decedent to, above)

Qualified use (see Qualified use of property as farm, requirement for special use valuation, above)

Recapture (see Recapture of special use valuation with interest, above)

Requirements for, 3.20

Stock (see Shares of stock, above)

Taxes

Basis (see Basis, above)

Estate taxes (see Estate tax considerations, above)

Farmer's tax guide (IRS Publication 225) as guidelines, 3.44

Generation-skipping taxes (see Generation-skipping transfer taxes, above)

Holding period for capital gains purposes, 3.65, 3.77

Income in respect of decedent (see Income in respect of decedent (IRD) farmer, above)

Special use valuation (see Special use valuation, above)

Trusts, family corporations, or family partnerships, balancing tax efficiency with retention of control by using, 3.13

Time

Installment payment of estate taxes (see Installment payment of estate taxes, above)

Recapture (see Recapture of special use valuation with interest, above)

Valuation

Conservation easements (see Conservation easements, above)

Discounts (see Discount in valuation, above)

Special use valuation (see Special use valuation, above)

Fees

See also **Costs; Expenses and Expenditures**

Animal companion trust, fees for caretaker and trustee, 6.4A, 6.24

Appraiser's fees, restrictions affecting, 7.23

Patent maintenance fees, payment of, 8.28

Practice administrator for solo practitioner, problems involving fees, 11.15

Fiduciaries

General partners, fiduciary duty of, 4.28

Personal representatives. See **Executors and Administrators**

Restricted securities. See **Restricted Securities**

Trustees. See **Trustees**

First Refusal, Right of

Family business, minority owner's right of first refusal on majority owner's sale or transfer of interests in, 2.3

Fractional Gifts. See Charitable Contributions

Fraud and Misrepresentation

Rule 10b-5 of Exchange Act, antifraud provisions of, 9.4

Freezing Estate Values. See Valuation

Gains and Losses. See Capital Gains and Losses

Generation-Skipping Transfers (GSTs)

Estate tax inclusion period (ETIP) ending after termination of qualified personal residence trust (QPRT), 4.22

Farms. See **Farms, Ranches, and Vineyards**

Grantor retained annuity trust (GRAT), GST tax considerations, 2.22

Qualified personal residence trust (QPRT), prohibition against allocating GST tax exemption to, 4.22

Gifts and Gift Taxes

Animals, gifts for. See **Companion Animals or Pets, Estate Planning For**

Annual exclusion

Amount of, 10.10

Family business, gift of interest qualifying for annual exclusion, 1.3

LLC membership units, gift not qualifying for annual exclusion, 1.3

Vacation property, transferring interests to younger generation and members by using annual exclusion, 4.30

Artwork. See **Art and Collectibles**

California domiciliary gifting out-of-state property located in decoupled state, 5.13

Charitable contributions. See **Charitable Contributions**

Circular 230, effect of, 1.40A

Community property, gifts of, 10.10

Copyright, gift tax issues involving, 8.20, 8.22

Definition of gift tax, 1.14

Exemptions

Amount of, 10.10

Table, gift tax exemptions and rates, 10.11

Family businesses. See Family Business Entities**;** Family Businesses, Succession Planning For

Farm, gift to younger generation of. See **Farms, Ranches, and Vineyards**

Grantor retained annuity trust (GRAT), gift tax on remainder interest in, 2.19

Nonqualified stock options (NQSOs). See **Stock Options**

Patents, gift tax issues involving, 8.32

Restricted securities. See **Restricted Securities**

Return, reporting gift tax on, 1.40

Special use valuation, unavailability for lifetime gifts, 3.19

Step-transaction doctrine, applicability to gifts of partnership interest, 1.37D

Taxable gifts, 10.10

Valuation. See **Valuation**

Grantor Retained Annuity Trust (GRAT)

Defined, 2.17

Family business, transfer of interest to GRAT. See **Family Businesses, Succession Planning For**

Restricted securities, transfer to GRAT. See **Restricted Securities**

Vacation home, effect of GRAT purchasing, 4.10

Grantor Retained Income Trust (GRIT)

Family members, elimination of GRIT among, 1.24

Grantor Trusts. See Family Businesses, Succession Planning For

Handicapped Persons. See Disabled Persons

Husband and Wife. See Spouses

Incapacity

Companion animal trust, provisions for settlor's incapacity. See **Companion Animals or Pets, Estate Planning For**

Farmer, incapacity of. See **Farms, Ranches, and Vineyards**

Incentive Stock Options. See Stock Options

Income in Respect of Decedent (IRD)

Copyright royalty payments, treatment of, 8.18

Defined, 3.74

Farms. See **Farms, Ranches, and Vineyards**

Growing crops not classified as, 3.14

Income Tax, Federal

Accumulated earnings tax, 2.4

Celebrity images, income from sale taxed as ordinary income, 8.35

Charitable contributions. See **Charitable Contributions**

Copyright, income tax on proceeds from sale of, 8.18

Corporations taxed as separate entities, 1.10

Dividend, distribution of C corporation's retained earnings treated as taxable, 3.6

Family business. See **Family Businesses, Succession Planning For**

Grantor retained annuity trust (GRAT), effect of treating as wholly-owned grantor trust for income tax purposes, 2.21

Kiddie tax for minors under age 14, 3.11

Limited liability company as flow-through entity for income tax purposes, 1.9

Limited partnerships not subject to, 4.16

Partnerships as flow-through entities for income tax purposes, 1.6

Patents. See **Patents**

Restricted securities, federal income tax law as constraint on sale of. See **Restricted Securities**

Stock options. See **Stock Options**

Valuation. See **Valuation**

Inheritance Taxes. See Estate and Inheritance Tax, State

Insider Trading

Section 16 of Exchange Act, insider trading prohibited by, 9.12

Installment Sales

Family business, installment sale to grantor trust. See **Family Businesses, Succession Planning For**

Restricted securities, installment sales to trusts for benefit of family members, 9.32

Insurance

Decline in stock value, increase in disability or life insurance as hedge against, 9.48

Intellectual Property

Copyrights. See **Copyrights**

Patents. See **Patents**

Trademarks or service marks. See **Trademarks or Service Marks**

Interest on Money

Deferred estate tax, interest on, 2.42

Farms. See **Farms, Ranches, and Vineyards**

Nonqualified stock options (NQSOs), determining factor for risk-free interest rate, 10.28

Interpretation of Cases and Statutes. See Construction and Interpretation

Interviews

Animal companions, checklist for client interview, 6.32

Inventions. See Patents

Investment Company

Contribution to investment company as taxable event, 1.13

IRS Challenging Validity of Business Entity

Generally, 1.37, 4.34

Applicability of IRC §2036(a)(1) and §2036(a)(2), 1.37A

Miscellaneous strategies to avoid IRC §2036(a), 1.37C

Planning responses to IRC §2036(a) attacks, 1.37E

Significant nontax or business purpose for formation of business entity, inapplicability of IRC §2036 if, 1.37B

Step-transaction doctrine, applicability to gifts of partnership interest, 1.37D

Last Illness and Funeral Expenses

Redemption of IRC §303 stock to pay funeral expenses, 2.41, 3.107

Law Practice, Disposition of

Generally, 11.1

Acting as practice administrator

Generally, 11.13

Active cases, disposition of, 11.15

Attorney fees, practice administrator handling problems concerning, 11.15

Client's files, disposition of, 11.14

Considerations in disposing of law practice, 11.14

Notifying clients of attorney's inability to continue representation, 11.15

Personal representative of estate or conservator, practice administrator working with, 11.13

Appointment of practice administrator (see Petition for appointment of practice administrator, below)

Buddy agreements, 11.1, 11.11

Client's files

Disposition of, 11.14

Ownership of, 11.13

Conservator

Cooperation between practice administrator and conservator, 11.13

Counsel for conservator, practice administrator prohibited from serving as, 11.15

Petition for appointment of practice administrator, conservator filing, 11.4

Executors (see Personal representative, below)

Nomination of practice administrator

Generally, 11.10

Form, nomination of practice administrator, 11.12

Informal agreement to take over friend's practice, replacement with nomination to act as practice administrator, 11.11

Notice

Petition for appointment of practice administrator, notice of, 11.5

Representation, notifying clients of attorney's inability to continue, 11.15

Personal representative

Cooperation between practice administrator and personal representative, 11.13

Counsel for personal representative, practice administrator prohibited from serving as, 11.15

Petition for appointment of practice administrator, personal representative filing, 11.4

Petition for appointment of practice administrator

Active membership in State Bar as requirement for appointment as practice administrator, 11.4

Contents of petition, 11.6

Form, petition for appointment of practice administrator, 11.8

Nomination of practice administrator (see Nomination of practice administrator, above)

Notice of petition, 11.5

Order appointing practice administrator, 11.9

Persons authorized to file petition, 11.4

Powers and duties of practice administrator, 11.7

Probate Code statutes authorizing, 11.3

Probate code, closing practice under, 11.3

State Bar Act, closing law practice under, 11.2

Successor counsel

Practice administrator becoming successor counsel, 11.14

Volunteer attorney appointed to assist clients in finding new counsel prohibited from becoming successor counsel, 11.1-11.2

Leases. See Farms, Ranches, and Vineyards

Letter Stock. See Restricted Securities

Licensing of Copyright. See Copyrights

Liens and Encumbrances

Estate taxes, lien on decedent's property to secure payment of, 3.62, 3.99

Family business, tax consequences of contributing encumbered assets to, 1.13

Life Estate

Charitable deduction, gift of art work to charitable organization with retained life estate resulting in postponement of, 7.30

Farm, disadvantage of retaining life estate in, 3.12

Life Insurance

Buy-sell agreement, funding with life insurance, 2.4

Limited Liability Company (LLC)

Annual gift tax exclusion, gift of LLC membership units not qualifying for, 1.3

California domiciliary contributing out-of-state property located in decoupled state to LLC, 5.14

Defined, 1.9

Family business entity, using LLC as. See **Family Business Entities**

IRS challenging validity of. See **IRS Challenging Validity of Business Entity**

Restricted securities, contribution to LLC, 9.33

Vacation property, LLC's ownership of. See **Vacation Homes, Estate Planning For**

Limited Partnerships

See also **Family Limited Partnership; Partnerships**

California domiciliary contributing out-of-state property located in decoupled state to limited partnership, 5.14

Defined, 4.16

Dissolution of, 1.7, 1.29

Family business entity, popularity of limited partnership as. See **Family Business Entities**

IRS challenging validity of. See **IRS Challenging Validity of Business Entity**

Liability of limited partners, 1.6

Liquidations, limited partner's right to vote on, 1.37C

Restricted securities, contribution to limited partnership, 9.33

Vacation home, limited partnership owning, 4.16

Liquidation

Family business entities. See **Family Business Entities**

Limited partner's right to vote on liquidations, 1.37C

Liquidity

Copyright interests, liquidity problems resulting from inclusion in estate, 8.23

Farm or ranch, liquidity issues involving, 3.6

Patents, 8.33

Litigation, IRS Challenging Validity of Business Entity. See IRS Challenging Validity of Business Entity

Livestock. See Farms, Ranches, and Vineyards

LLCs. See Limited Liability Company (LLC)

Loans

Restricted stock as security for loan, 9.35, 9.55

Losses. See Capital Gains and Losses

Maintenance. See Repairs and Maintenance

Marital Deduction

Copyrights, marital deduction for, 8.21

Farms and ranches. See **Farms, Ranches, and Vineyards**

Patents, marital deduction for, 8.32

Phase-out of federal estate tax, qualifying additional property for marital deduction as means of avoiding state death taxes, 5.18

Reduction of marital deduction by "phantom" tax, 5.16A

Marketability, Discount For Lack of. See Discounts

Marriage. See Spouses

Medicare

Dissolution of marriage, treatment of transfer of stock option to spouse for purposes of Medicare taxes, 10.34

Nonqualified stock options, withholding for Medicare taxes, 10.8

Minors. See Parent and Child

Misrepresentations. See Fraud and Misrepresentation

Modifications. See Amendments and Modifications

Nonqualified Stock Options (NQSOs). See Stock Options

Notice and Notification

Copyright, author delivering written notice of exercise of termination rights to grantees, 8.17

Farms, notice of special use valuation for. See **Farms, Ranches, and Vineyards**

Law practice, disposition of. See **Law Practice, Disposition of**

Options. See Stock Options

Orders

Practice administrator, order appointing, 11.9

Out-of-State Property. See Estate and Inheritance Tax, State

Ownership. See Possession and Ownership

Parent and Child

Kiddie tax for minors under age 14, 3.11

Property tax reassessment exclusion for transfers between, 1.52

Partition

Tenant in common's right to petition court for partition of property, 4.13

Partnerships

See also **Limited Partnerships**

Closely held businesses. See **Closely Held Businesses**

Defined, 1.6, 4.14

Farms. See **Farms, Ranches, and Vineyards**

General partnerships

Generally, 4.15

Fiduciary duty of general partners, 4.28

IRS challenging validity of. See **IRS Challenging Validity of Business Entity**

Step-transaction doctrine, applicability to gifts of partnership interest, 1.37D

Vacation homes, partnership owning. See **Vacation Homes, Estate Planning For**

Patents

Generally, 8.1, 8.24

Annual gift tax exclusion, gift of partnership interest qualifying for, 1.3

Assignment of, 8.29

Constitutional basis for patents, 8.25

Grant of patent by Patent and Trademark Office

Application for patent, 8.26

Duration of patent, 8.28

Extension of patent term, 8.28

Ownership of patent, 8.29

Protection offered by patent grant, 8.27

History of patent law in United States, 8.25

Income tax (see Tax issues, below)

Maintenance fees, 8.28

Tax issues

Charitable contributions of patents, 8.31

Gift and estate tax issues, 8.32

Income tax treatment of patents, 8.30

Liquidity issues, 8.33

Pension Plans. See Retirement and Pension Plans

Pension Protection Act of 2006. See Charitable Contributions

Personal Representative. See Executors and Administrators

Personal Residence

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Vacation homes. See **Vacation Homes, Estate Planning For**

Petitions

Practice administrator for solo practitioner, petition for appointment of. See **Law Practice, Disposition of**

Tenant in common's right to petition court for partition of property, 4.13

Pets. See Companion Animals or Pets, Estate Planning For

Phase Out of State Death Tax Credit. See Estate and Inheritance Tax, State

Possession and Ownership

See also **Title**

Client's files, ownership of, 11.13

Vacation home, ownership of. See **Vacation Homes, Estate Planning For**

Power of Appointment

Special use valuation, effect of exercising power of appointment in favor of nonfamily member on property's eligibility for, 3.29

Power of Attorney. See Durable Power of Attorney

Practice Administrator For Solo Practitioner. See Law Practice, Disposition of

Private Operating Foundation. See Charitable Contributions

Proof

See also **Burden of Proof**

Related use rule, correspondence with charitable organization to establish proof necessary to meet, 7.24

Property Taxes

Change of ownership defined, 4.35

Family business entity, consequences of transferring real property to, 1.52

Gifts of farmland resulting in revaluation for property tax purposes, 3.12

Parent-child exclusion from reassessment, 1.52

Vacation property, attorney's evaluation of planned transfer of interest on property taxes, 4.35

Qualified Domestic Trust (QDOT)

Installment payment of estate tax on property in, 3.103

Qualified Personal Residence Trust (QPRT)

Defined, 4.20

Estate tax inclusion period (ETIP) ending after termination of QPRT, 4.22

Vacation home, transferring to QPRT. See **Vacation Homes, Estate Planning For**

Qualified Subchapter S Trust (QSST). See Family Businesses, Succession Planning For

Qualified Terminable Interest Property (QTIP)

Farms. See **Farms, Ranches, and Vineyards**

Phase-out of state death tax credit, QTIP trust as means of avoiding state death taxes. See **Estate and Inheritance Tax, State**

Questionnaires. See Charts, Checklists, Questionnaires, and Tables

Questions of Law and Fact

Fair market value as question of fact, 7.52

Valuation of property for federal estate and gift tax as question of fact, 4.31

Ranches. See Farms, Ranches, and Vineyards

Real Property

Farms and ranches. See **Farms, Ranches, and Vineyards**

Personal residence. See **Personal Residence**

QPRT. See **Qualified Personal Residence Trust (QPRT)**

Taxes. See **Property Taxes**

Vacation homes. See **Vacation Homes, Estate Planning For**

Recordation of Documents

Patent assignment, recordation of, 8.29

Records and Reports

Gift tax return, reporting gifts on, 1.40

Restricted securities, reporting requirements affecting. See **Restricted Securities**

Stock options, reporting obligations for transfer to former spouse after dissolution of marriage, 10.35

Redemption of IRC §303 Stock

Estate tax, redemption of stock to pay, 2.41

Farming corporation stock, redemption of. See **Farms, Ranches, and Vineyards**

Relatives

Children. See **Parent and Child**

Definition of "family member," 2.5, 10.19

Spouses. See **Spouses**

Stock option, transfer to family members. See **Stock Options**

Succession planning for family business. See **Family Businesses, Succession Planning For**

Vacation property, transferring interest to family member. See **Vacation Homes, Estate Planning For**

Renewal of Copyright. See Copyrights

Rent. See Farms, Ranches, and Vineyards

Reorganization

Acceleration of deferred estate tax, reorganization not treated as distribution resulting in, 3.95

Repairs and Maintenance

Vacation homes, planning for maintenance of, 4.7

Reports. See Records and Reports

Residence. See Personal Residence

Restricted Securities

Generally, 9.1

Cashless collar, hedging risk with

Generally, 9.40

Defined, 9.37, 9.40

Diagram, 9.41

Disadvantages of, 9.43

GRATs (see Grantor retained annuity trusts (GRATs), below)

Reporting requirements, 9.42

Charitable gift of restricted securities

Constraints on charitable entities, 9.27

Reporting requirements for charitable gifts, 9.26

Tax advantages of, 9.58

Types of charitable gifts, 9.25

Charts, diagrams, and tables

Cashless collar, 9.41

Estate protection option, hedging as, 9.52

Grantor retained annuity trusts (GRATs), economics of option transactions within, 9.45

Matrix of securities law considerations related to restricted or control stock, 9.60

Personal exchange funds, 9.47

Put options, 9.39

Constraints on restricted securities

Generally, 9.2

Federal securities laws (see Federal securities laws, below)

Federal tax law (see Federal tax law as constraint on sale of restricted stock, below)

State securities law, 9.14

Definition of restricted stock, 9.5

Derivative transaction, hedging risk with

Generally, 9.36

Cashless collar (see Cashless collar, hedging risk with, above)

Fiduciary's powers to invest in derivative instrument, 9.55

Put options, purchase of, 9.38-9.39

Terminology of, 9.37

Diagrams (see Charts, diagrams, and tables, above)

Diversification, selling stock for purpose of

Generally, 9.21

Block of stock, practical considerations in selling, 9.23

Holding versus selling analysis, 9.22

Individual investor, diversification issues for, 9.22-9.23

Securities laws considerations in selling stock, 9.24

Estate protection option by fiduciary

Hedging versus selling stocks, 9.51

Table, example of hedging as estate protection option, 9.52

Executors (see Postdeath administration, planning for, below)

Family, transferring portion of holdings to

Generally, 9.28

Gift of securities, disclosure of, 9.29

Grantor retained annuity trust (GRAT), transfer to (see Grantor retained annuity trusts (GRATs), below)

Limited partnerships or limited liability companies, contributions to, 9.33

Trusts or individuals, installment sales to, 9.32

Trusts, transfers to, 9.30-9.31D

Federal securities laws

Generally, 9.3

Rule 10b-5, 9.4, 9.24

Rule 144 (see Rule 144 of Securities Act, below)

Rule 145 of Securities Act, applicability to former insiders of acquired company, 9.11

Section 13 of Exchange Act, requirement of reporting holdings by persons holding more than 5 percent of outstanding class of voting equity, 9.13

Section 16 of Exchange Act (see Section 16 of Exchange Act, below)

Federal tax law as constraint on sale of restricted stock

Generally, 9.15

Compensatory stock and IRC §83(b) election, 9.17

Death, restricted or control stock at, 9.18

Estate tax deferral, applicability to shareholder of publicly-traded corporation, 9.19

Gain recognition, deferral of, 9.16

Fiduciaries (see Postdeath administration, planning for, below)

Gifts

Charitable gifts (see Charitable gift of restricted securities, above)

Disclosure of, 9.29

Grantor retained annuity trust, transferring gift of stock to (see Grantor retained annuity trusts (GRATs), below)

Holding period for stock acquired by gift, 9.29, 9.31-9.31D

Grantor retained annuity trusts (GRATs)

Annuity term, end of, 9.31D

Diagram, economics of options transactions within GRATs, 9.45

Put and call options within, 9.44

Rule 144 requirements, 9.31A, 9.31D

Section 13(d) requirements, 9.31B, 9.31D

Section 16 requirements, 9.31, 9.31C-9.31D

Transfer of stock to, generally, 9.31

Holding period for restricted stock

Generally, 9.6

Gift, holding period for stock acquired by, 9.29, 9.31-9.31D

Hedging stock acquired by exercise of incentive stock option, effect of, 9.42

Income taxes (see Federal tax law as constraint on sale of restricted stock, above)

Lifetime, estate planning alternatives during

Charity (see Charitable gift of restricted securities, above)

Combining borrowing, hedging, and tax deferral with prepaid, variable delivery forward sale, 9.46-9.47

Derivative transaction (see Derivative transaction, hedging risk with, above)

Diagrams (see Charts, diagrams, and tables, above)

Diversification (see Diversification, selling stock for purpose of, above)

Exchange fund, investing portion of stock in, 9.34

Family (see Family, transferring portion of holdings to, above)

Insurance coverage, increase in, 9.48

Loan, pledging restricted stock as security for, 9.35

Nonvested stock, deferring income recognition on, 9.20

Nonvested compensatory stock

Generally, 9.20

Defined, 9.17

Postdeath administration, planning for

Generally, 9.49

Borrowing, authorizing fiduciary to pledge stock as security for, 9.55

Charitable gifts, tax advantages of, 9.58

Discretion of personal representative or trustee to sell restricted securities, 9.54

Estate planning option (see Estate protection option by fiduciary, above)

Exculpatory language insulating personal representative or trustee from liability, 9.56

Investment powers of fiduciary, 9.55

Retention of securities, estate planner authorizing, 9.53

Selection of fiduciary, 9.50

Valuation and distribution problems, 9.57

Reports

Cashless collar, reporting requirements, 9.42

Charitable gifts, reporting requirements for, 9.26

Rule 144 (see Rule 144 of Securities Act, below)

Section 13 of Exchange Act, requirement of reporting holdings by persons holding more than 5 percent of outstanding class of voting equity, 9.13

Resolving conflicts for corporate trustees in relation to investments, 9.59

Rule 144 of Securities Act

Application of rule to restricted stock and letter stock, 9.5

Cashless collar, no reporting requirements under Rule 144, 9.42

Concentrated position, individual investor's sale of, 9.24

Exchange fund, Rule 144 filing not required on contribution to, 9.34

Exemptions, 9.32

Grantor retained annuity trust, Rule 144 requirements for, 9.31A, 9.31D

Holding period for restricted stock, 9.6, 9.31-9.32

Limited partnerships or limited liability companies, contribution of stock not constituting sale for Rule 144 purposes, 9.33

Manner of sale of securities, 9.9

Matrix of securities law considerations related to restricted or control stock, 9.60

Put option, no reporting requirement for purchase of, 9.38

Reporting requirements for sale of stock, 9.7, 9.10

Volume limits on sale of stock, 9.8

Section 16 of Exchange Act

Estate transactions, 9.12A

Insider trading prohibited by, 9.12

Trust transactions, 9.12B

Taxes

Basis adjustment at stockholder's death, 9.18, 9.42

Cashless collar, tax consequences of, 9.42

Charitable gifts, tax advantages of, 9.58

Constraint on sale of restricted stock (see Federal tax law as constraint on sale of restricted stock, above)

Trustees (see Postdeath administration, planning for, above)

Trusts

GRATs (see Grantor retained annuity trusts (GRATs), above)

Transfer of stock to trusts (see Family, transferring portion of holdings to, above)

Retention of Interest or Enjoyment of Property. See IRS Challenging Validity of Business Entity

Retirement and Pension Plans

Farm, special use valuation rules applicable to retired owner of, 3.38

Returns. See Tax Returns

Salaries and Compensation

Fees. See **Fees**

Stock options. See **Stock Options**

Sale of Property

Artwork. See **Art and Collectibles**

California domiciliary selling out-of-state property located in decoupled state, 5.12

Capital gains. See **Capital Gains and Losses**

Residence, sale of, 3.66

Vacation home, effect of sale to family members or grantor retained annuity trust (GRAT), 4.10

S Corporations

Distribution from S corporation, tax treatment of, 3.6

Family businesses. See **Family Businesses, Succession Planning For**

Installment payment of estate tax, estate's eligibility as shareholder for period governing, 3.104

Qualified subchapter S trust (QSST). See **Family Businesses, Succession Planning For**

Secured Transactions

Lien on estate property as security for unpaid estate taxes, 3.99

Restricted stock as security for loan, 9.35, 9.55

Securities Laws

Nonqualified stock options, securities laws considerations, 10.19, 10.31

Restricted stock, effect of federal and state securities laws on. See **Restricted Securities**

Securities. See Shares and Shareholders

Settlement

Valuation issues in charitable donation cases, settlement of, 7.61

Shares and Shareholders

See also **Corporations**

Dividends. See **Dividends**

Family businesses. See **Family Businesses, Succession Planning For**

Farming corporation stock. See **Farms, Ranches, and Vineyards**

Redemption of stock. See **Redemption of IRC §303 Stock**

Restricted securities. See **Restricted Securities**

Stock options. See **Stock Options**

Social Security

Dissolution of marriage, treatment of transfer of stock options to spouse for Social Security purposes, 10.34

Nonqualified stock option, withholding for Social Security, 10.8

Special Use Valuation. See Farms, Ranches, and Vineyards

Spouses

Community property. See **Community Property**

Dissolution of marriage, transfer of stock options after. See **Stock Options**

Family business. See **Family Businesses, Succession Planning For**

Interspousal transfer of property not constituting change of ownership, 4.35

Marital deduction. See **Marital Deduction**

Phase-out of federal estate tax, planning options for spouses. See **Estate and Inheritance Tax, State**

Surviving spouse. See **Surviving Spouse**

State Death Tax Credit. See Estate and Inheritance Tax, State

Step-Transaction Doctrine

Gifts of partnership interest, applicability of doctrine to, 1.37D

Stock Options

Generally, 10.1

Capital gains tax

Incentive stock option (ISO), 9.42, 10.5, 10.44

Nonqualified stock option (NQSO), 10.18

Charity, transfer of NQSOs to

Charitable deduction, 10.29

Example of transferring NQSO to charity, 10.30

Securities laws, effect on gift of NQSO to charity, 10.31

Checklists and tables

Estate tax, table of exemption amounts and rates, 10.17

Gift tax, table of exemptions and rates, 10.11

Nonemployee spouse, checklist of company's responsibilities regarding transfer of options to, 10.38

Death of optionee, disposition of stock options on

Beneficiary designation, 10.42, 10.43

Incentive stock options, estate's or heir's exercise of, 10.40

Nonqualified stock options, estate or heir's exercise of, 10.41

Defined, 10.2

Dissolution of marriage, transfer of NQSO on

Conversion of incentive stock option to nonqualified stock option on transfer to former spouse, 10.36

Nonemployee spouse, checklist of company's responsibilities regarding transfer of options to nonemployee spouse, 10.38

Nonemployee spouse, effect of optionee exercising option on behalf of, 10.37

Option transfer, consent, and indemnity agreement, 10.39

Reporting obligations after transfer of stock option to spouse, 10.35

Social Security, Medicare, federal unemployment taxes, income taxes, treatment of option transfers for purposes of, 10.34

Tax-free division of marital property, transfer of NQSO treated as, 10.33

Estate taxes on NQSOs

Generally, 10.16

Table, estate tax exemption amounts and rates, 10.17

Expiration of, 10.2

Fair market value

Nonqualified stock option, increasing exercise price to fair market value of stock on original grant date, 10.8

Safe harbor method of determining fair market value of transferred stock option, 10.29

Transfer of nonqualified stock option to family member without consideration, imposition of gift taxes on fair market value of stock option, 10.12

Gift tax consequences of transferring NQSOs

Generally, 10.9-10.10

Annual exclusion, amount of, 10.10

Examples, gift of NQSO to family members, 10.13-10.15

Securities laws considerations, 10.19

Table, gift tax exemptions and rates, 10.11

Transfer of NQSO to family member without consideration, imposition of gift taxes on fair market value of NQSO, 10.12

Unvested NQSOs, gift of, 10.15

Vested NQSOs, gift of, 10.14

Incentive stock options (ISOs)

Alternative minimum tax liability on exercise of, 10.6, 10.44

Capital gains tax, 9.42, 10.5, 10.44

Death of optionee, exercise of options by estate or heir, 10.40

Defined, 10.3

Example of tax calculations for single taxpayer on exercise and sale of, 10.44

Hedging stock acquired by exercise of ISO, effect on holding period for long-term capital gain treatment, 9.42

Income tax advantages of, 10.5

Qualification of stock option as ISO, 10.4

Transfer of ISO, restrictions on, 10.4, 10.29

Income taxes

Capital gains (see Capital gains tax, above)

Dissolution of marriage (see Dissolution of marriage, above)

Incentive stock options, 10.5

Nonqualified stock options, charitable deduction, 10.29

Nonqualified stock options, taxing gains from, 10.8

Nonqualified stock options, tax on transfers of, 10.18

Medicare. See **Medicare**

Nonqualified stock options (NQSOs)

Generally, 10.8

Capital gains tax, 10.18

Charity (see Charity, transfer of NQSOs to, above)

Death of optionee, exercise of options by estate or heir, 10.40

Defined, 10.3

Estate taxes (see Estate taxes on NQSOs, above)

Family limited partnership, transfer of NQSO to, 10.32

Gift taxes (see Gift tax consequences of transferring NQSOs, above)

Income taxes (see Income taxes, above)

Securities laws considerations, 10.19, 10.31

Unvested NQSO (see Unvested nonqualified stock options, below)

Valuation (see Valuation of NQSOs, below)

Withholding, 10.8, 10.33

Relatives, gift of NQSO to (see Gift tax consequences of transferring NQSOs, above)

Social Security. See **Social Security**

Tables (see Checklists and tables, above)

Taxes

Estate taxes (see Estate taxes on NQSOs, above)

Gift taxes (see Gift tax consequences of transferring NQSOs, above)

Incentive stock options (see Incentive stock options (ISOs), above)

Income taxes (see Income taxes, above)

NQSOs (see Nonqualified stock options (NQSOs), above)

Types of stock options

Generally, 10.3

Incentive stock options (see Incentive stock options (ISOs), above)

NQSO (see Nonqualified stock options (NQSOs), above)

Unvested nonqualified stock options

Charitable deduction for gift of unvested NQSO, 10.29

Gift tax consequences of gifting unvested NQSO, 10.15

Valuation of NQSOs

Generally, 10.20

Computed expected life of option, 10.25

Expected dividends on underlying stock, determining factor for, 10.27

Expected life of option, determining factors for, 10.23-10.25

Factors in option pricing model, 10.22-10.28

Increasing exercise price to fair market value of stock on original grant date of option, 10.8

Maximum remaining term, calculating life of option by using, 10.24

Risk-free interest rate, determining factor for, 10.28

Safe harbor method for valuing options, 10.21

Volatility of underlying stock, determining factor for, 10.26

Vesting period, 10.2

Withholding

Incentive stock options, 10.7

Nonqualified stock options, 10.8, 10.33

Succession Planning For Family Businesses. See Family Businesses, Succession Planning For

Successor Counsel. See Law Practice, Disposition of

Surety Bonds

Estate taxes, IRS requesting executor to post bond for unpaid, 3.99

Practice administrator posting surety bond for assets in sole practitioner's law practice, 11.6

Surviving Spouse

Copyrights. See **Copyrights**

Disclaimer by, 5.22

Farms and ranches. See **Farms, Ranches, and Vineyards**

Phase-out of state death tax credit, effect on surviving spouse. See **Estate and Inheritance Tax, State**

Tables. See Charts, Checklists, Questionnaires, and Tables

Taxes

Basis. See **Basis**

Companion animals, tax issues in drafting trusts for. See **Companion Animals or Pets, Estate Planning For**

Copyrights. See **Copyrights**

Estate tax. See **Estate and Inheritance Tax, State; Estate Tax, Federal**

Family businesses. See **Family Business Entities**

Farms and ranches. See **Farms, Ranches, and Vineyards**

Generation-skipping transfer taxes. See **Generation-Skipping Transfers (GSTs)**

Gift taxes. See **Gifts and Gift Taxes**

Income tax. See **Income Tax, Federal**

IRC §2036, IRS challenging validity of business entity under. See **IRS Challenging Validity of Business Entity**

Marital deduction, reduction by "phantom" tax, 5.16A

Patents. See **Patents**

Property taxes. See **Property Taxes**

Restricted securities. See **Restricted Securities**

Returns. See **Tax Returns**

Stock options, taxation of. See **Stock Options**

Vacation homes. See **Vacation Homes, Estate Planning For**

Tax Returns

Gift tax return, adequate disclosure requirement for, 1.40

Special use valuation, filing election with estate tax return, 3.50

Tenancy in Common

Copyright, joint author's co-ownership of, 8.7

Vacation homes. See **Vacation Homes, Estate Planning For**

Termination of Employment

Stock option, expiration on termination of employment, 10.2

Termination of Trust for Pet. See Companion Animals or Pets, Estate Planning For

3 Years Within Death

Farms and ranches, 3.33, 3.102

Time

Charitable contributions, timing limitation for fractional gifts under IRC §170(o), 7.28B

Copyrights, duration of. See **Copyrights**

Electing small business trust (ESBT), time limit for, 2.37

Extension of time. See **Extension of Time**

Farms. See **Farms, Ranches, and Vineyards**

Patent, duration of, 8.28

Stock options, vesting period and expiration of, 10.2

Title

See also **Possession and Ownership**

Vacation home, title and control of, 4.3

Trademarks or Service Marks

Generally, 8.1

Abandonment of trademark, 8.33F

Defined, 8.33A

Family businesses

Personal name mark situations, 8.33H

Sole proprietorships or closely held businesses, 8.33G

Wills or trusts, assignments in, 8.33I

Federal protection (Lanham Act), 8.33D

History of trademark law, 8.33B

State protection (common law rights from use), 8.33C

Trademarkability, 8.33E

Trustees

Companion animal, trustee for. See **Companion Animals or Pets, Estate Planning For**

Electing small business trust (ESBT), trustee's election of, 2.37

Restricted securities, postdeath administration of. See **Restricted Securities**

Trusts

Bypass trust. See **Bypass Trust**

Charitable remainder trust. See **Charitable Remainder Trust**

Companion animals, trust providing for. See **Companion Animals or Pets, Estate Planning For**

Family businesses. See **Family Businesses, Succession Planning For**

Farms. See **Farms, Ranches, and Vineyards**

Federal and state estate tax exclusions, effect on marital trust, 5.16

Grantor retained income trust (GRIT), elimination among family members, 1.24

GRAT. See **Grantor Retained Annuity Trust (GRAT)**

QPRT. See **Qualified Personal Residence Trust (QPRT)**

QTIP. See **Qualified Terminable Interest Property (QTIP)**

Qualified domestic trust (QDOT), installment payment of estate tax on property in, 3.103

Qualified subchapter S trust (QSST). See **Family Businesses, Succession Planning For**

Restricted securities, transfer to trust for family members. See **Restricted Securities**

S corporation stock, trust's eligibility to hold, 2.31

Trademark assignments in trusts, 8.33I

Vacation property, trust owning. See **Vacation Homes, Estate Planning For**

Vacation Homes, Estate Planning For

Generally, 4.1

Conservation easements, tax advantages of

Generally, 4.23

Estate tax exclusion and deduction, 4.25

Income tax deduction, 4.24

Deductions (see Conservation easements, tax advantages of, above)

Discounts (see Value of transferred interests, reducing through use of discounts, below)

Easements (see Conservation easements, tax advantages of, above)

Limited liability company (LLC), ownership of vacation property by

Generally, 4.17

Change of ownership, transfer of vacation property to LLC not constituting, 4.35

Gift tax annual exclusion, creating LLC to take advantage of, 4.30

Sample management procedures, 4.36

Partnership as alternative to collective ownership of vacation property

Generally, 4.14

Change of ownership, transfer of vacation property to partnership not constituting, 4.35

General partnership, 4.15

IRS challenging validity of family limited partnership, 4.34

Limited partnership, ownership of vacation property by, 4.16

Possession or enjoyment of transferred property, effect of general partner retaining right to determine, 4.28

Revocable trust as alternative to, 4.19

Sample management procedures, 4.36

Planning issues

Generally, 4.2

Equal access of family members to property, 4.6

Limiting liability of owners, 4.4

Maintenance of property, 4.7

Management of vacation property, 4.5

Title and ownership, 4.3

Transferability of interest, 4.8

Property taxes, attorney's evaluation of planned transfer of interest in vacation property on, 4.35

Qualified personal residence trust (QPRT), transfer of vacation property to

Generally, 4.20

Change of ownership, transfer of vacation property to QPRT not constituting, 4.35

Disadvantages of, 4.22

Requirements and permissible terms for QPRT, 4.21

Retained interests, tax issues involving

Alter, amend, revoke, or terminate transfer, effect of transferor retaining right to, 4.29

Determine possession or enjoyment of property, effect of transferor retaining right to, 4.28

Right of possession or enjoyment, effect of taxpayer retaining, 4.27

Structuring ownership of vacation property, planning options for

Generally, 4.9

Conservation easements (see Conservation easements, tax advantages of, above)

LLC (see Limited liability company (LLC), ownership of vacation property by, above)

Partnership (see Partnership as alternative to collective ownership of vacation property, above)

Tenancy in common (see Tenancy in common, below)

Trusts (see Trust, transferring vacation property to, below)

Tenancy in common

Generally, 4.11

Advantages and disadvantages of, 4.12

Cotenancy agreement, 4.13

Revocable trust as alternative to cotenancy agreement, 4.19

Sample cotenancy agreement, 4.39

Transfer tax issues

Generally, 4.26

Gift tax annual exclusion, transferring interests in vacation property to younger generation family members by using, 4.30

Retained interests (see Retained interests, tax issues involving, above)

Value of transferred interests (see Value of transferred interests, reducing through use of discounts, below)

Trust, transferring vacation property to

Irrevocable trust, 4.18

QPRT (see Qualified personal residence trust (QPRT), transfer of vacation property to, above)

Revocable trust as alternative to cotenancy agreement or general partnership, 4.19

Sale of property to family members or grantor retained annuity trust (GRAT), effect of, 4.10

Sample lake home trust, 4.38

Sample vacation home trust provisions, 4.37

Value of transferred interests, reducing through use of discounts

Generally, 4.31

IRS challenge to valuation discount, 4.34

Lack of control (minority) discount, 4.32

Lack of marketability discount, 4.33

Validity of Business Entity, IRS Challenging. See IRS Challenging Validity of Business Entity

Valuation

See also **Appraisers and Appraisals**

Art (see Fair market value, below)

Auctions

Absolute measure of fair market value, auction prices not, 7.48

Relevant retail market determined by auction market, 7.54

Charitable contributions

Generally, 7.44

Appraisal of tangible personal property, 7.45

Fair market value, determination of (see Fair market value, below)

Fractional interest, valuation of, 7.27, 7.28A

IRS valuation regulations, 7.45

Conservation contribution, determining value of, 4.24

Copyrights, valuation of, 8.22

Current trend in valuation cases, 7.61

Discounts. See **Discounts**

Fair market value

Auctions (see Auctions, above)

Defined, 1.14, 3.18, 4.31, 7.45

Family business buy-sell agreement, valuing stock at fair market value, 2.4

Family businesses. See **Family Business Entities**

IRS advance ruling on art valuations for income, gift, and estate tax purposes, taxpayer's request for, 7.47

IRS determining value of donated works of art and cultural property, 7.46

Litigating fair market value (see Litigating fair market value, below)

Minority or noncontrolling interest in closely held entity, fair market value of, 1.14

Premiums, fair market value of interest in family business entity. See **Family Business Entities**

Question of fact, fair market value as, 7.52

Relevant market (see Relevant market as factor in determining fair market value, below)

Stock options. See **Stock Options**

Family businesses. See **Family Business Entities; Family Businesses, Succession Planning For**

Farms. See **Farms, Ranches, and Vineyards**

Freezing estate values

Nonvoting common stock, majority shareholder's transfer to company resulting in freezing value for estate and gift tax purposes, 2.15

Qualified personal residence trust (QPRT) as estate freezing device, 4.20

Vacation home, freezing value for purposes of estate tax, 4.10

Litigating fair market value

Generally, 7.48

Estate inclusion value consistent with deduction value, 7.60

Relevant market (see Relevant market as factor in determining fair market value, below)

Nonqualified stock options, valuation of. See **Stock Options**

Question of fact. See **Questions of Law and Fact**

Question of fact, valuation of property as, 4.31

Relevant market as factor in determining fair market value

Art galleries, relevant retail market determined by, 7.53

Auction market, relevant retail market determined by, 7.54

Authenticity, reduction in value resulting from dispute over, 7.58

Blockage discount, retail market value with, 7.51

Collector's market as appropriate marketplace, 7.55

Comparable sales prices, identifying appropriate marketplaces to find, 7.56

Glamour premium, effect on artifact's value, 7.57

Market data comparison approach, 7.52

Middleman market, relevant retail market as, 7.50

Stolen property, valuation of, 7.59

Wholesale market as relevant market, 7.49

Restricted and control securities, valuation of, 9.57

Settlement of valuation issues, 7.61

Special use valuation. See **Farms, Ranches, and Vineyards**

Stock options. See **Stock Options**

Vacation property. See **Vacation Homes, Estate Planning For**

Vineyards. See Farms, Ranches, and Vineyards

Wages. See Salaries and Compensation

Waiver

Practice administrator for solo practitioner, waiver of notice of petition for appointment of, 11.5

Websites

Animal protection organizations, 6.9

Wills

Companion animals. See **Companion Animals or Pets, Estate Planning For**

Trademark assignments in wills, 8.33I

Withholding. See Stock Options

Witnesses. See Experts and Expert Witnesses

Words and Phrases. See Construction and Interpretation; Definitions

Works For Hire. See Copyrights

© The Regents of the University of California