Heckerling Institute Report
Report #9 - Thursday Morning Sessions

The following is Report #9 from our on-site reporters regarding some of the highlights from the events and presentations that are taking place at the 34th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 10-14, 1999 at the Fontainebleau Hilton in Miami Beach, Florida.

This Report covers all the **Thursday morning sessions**, which included **Daniel Markstein** on **Stock Options**, **Byrle Abbin** on **Economics of CRTs**, **James Narron** on **Inter Vivos Noncharitable Gifts**, and **Jerome Hesch** on **Beyond the Freeze**.

This report was filed by on-site reporter, and Miami resident, Bruce Stone. Bruce is also a member of the Institute's Advisory Committee.

Daniel Markstein: Daniel Markstein of Birmingham, Alabama, opened the Thursday session with a presentation on planning opportunities with stock options.

He gave a general review of the income tax rules governing stock options under section 83. Options which have a readily ascertainable value cannot be the subject of an election under section 83(b) election to accelerate income into the year of receipt, but the only options which have a readily ascertainable value are options which are publicly traded. The receipt of options which do not have a readily ascertainable value do not result in the realization of income (unless a section 83(b) election is made), and income will not be realized until the options are exercised, even if in the interim the options acquire a readily ascertainable value.

Making a gift of an option does not result in taxable income. When the donee exercises the option, the donor realizes income, and the donee acquires a basis adjustment for the amount of income realized by the donor. But if the donor dies before the option is exercised, who realizes income upon exercise? Two PLRs indicate that the donor's estate realizes income (199927002 and 9616035), but Dan doesn't think this conclusion is supported by section 83, because under that section the transfer of an option is not a realization event if there is no readily ascertainable value. As a planning pointer, if options are exercised before during lifetime, the uncertainty of who pays the tax is eliminated, and the income tax will reduce the size of the estate (or will be a section 2053 deduction if death occurs before the income tax is paid by the donor). Dan mused whether a provision in the option agreement stating that an option will be deemed exercised if death of the optionholder is imminent would work to achieve this result.

To prevent untimely and undesired realization of income by a donee's exercise of an option, the option should be given to a trust. Whether the trust is a grantor trust or not isn't critical with respect to the option itself, because the donor will be taxed upon the exercise of the option in any event under section 83. The advantages of using a grantor trust would be with respect to other income, including income earned after exercise of the option.

Dan discussed Rev. Rul. 98-21, in which the Service ruled a completed gift does not occur when an employee transfers options which are conditioned on the performance of future services. PLR 199952012 goes further and suggests that if an option is not exercisable because price targets have not been met yet, a gift of the option is not a completed gift. Dan believes that RR 98-21 is wrong, and that the PLR is even less defensible. The AICPA and ACTEC also have gone on record agreeing that RR 98-21 is wrong. Dan observed that you can plan around the ruling, however.

Finally, Dan discussed Rev. Proc. 98-34, which gives factors for valuing options for transfer tax purposes. But it applies on to the valuation of nonpublicly traded options for stock that itself is traded on an established securities market, and thus it doesn't give guidance on valuing options to acquire stock that is not publicly traded. Furthermore, it does not allow for any discounts in value based on marketability.

Byrle Abbin: Byrle Abbin of Washington, D.C. then discussed the economics of charitable remainder trusts.

He believes that the "Chutzpah trust" regulations will be hard for the Service to sustain against challenges in court without statutory authority. He summarized the 1997 law changes to CRTs, referring the audience to his outline for a detailed discussion.

He stated that it is his belief that it is malpractice for a drafter not to include a provision in a CRT allocating post-contribution gain to trust accounting income.

James Narron: James Narron of Smithfield, North Carolina discussed the concepts and mathematics of making noncharitable inter vivos gifts.

He observed that many planners labor under the illusion that gifts remove appreciation from the transfer tax system. But if the tax rates remain constant, it does not matter when a gift is made. However, if delaying a gift will cause future appreciation to be taxed in a higher marginal rate bracket, there may be an advantage to making the gift earlier. However, if the value of a gifted asset drops in the future, there is a tax disadvantage to having made the gift, because the gifted value will be included in the base of adjusted taxable transfers at its higher value.

He explored an example in his materials (filled with many excellent examples) which assumed a deceased spouse with a $10 million estate, a surviving spouse who survives more than 10 years with a $1 million separate estate, and where assets double in value before the surviving spouse's estate. Of the three possibilities (optimum marital deduction on the first death, equalizing the two estates on the first death, and the surviving spouse making a taxable gift of a marital bequest), the lowest taxes were incurred by the surviving spouse receiving a marital bequest and making a taxable gift.

He spoke on the increasing need for and importance of appraisals under the gift tax disclosure regulations, and wondered how this is going to affect smaller estates where the expenses of obtaining appraisals often aren't warranted. He felt that the estate planning lawyer will have responsibility to deal with this situation, because if appraisals aren't obtained and adverse results follow, the planner will be blamed.

He characterized planning lesson number one as making gifts to obtain discounts that apply only during life. Lesson number two is to use QTIP trusts to capture minority interest discounts that otherwise might not be available (citing the Bonner and Mellinger cases). Other directives were never to let your client die owning the fee interest in real estate, and to work very closely with appraisers when conducting estate planning transactions.

He admonished the use of caution in certain types of gifts, such as items of IRD, or making gifts that treat children unequally if the client attempts to "equalize" among the children upon death. Often drafting lawyers do not take into account all of the factors that must be considered when a client wishes to make unequal gifts at death in order to equalize for lifetime gifts (factors such as benefits of the unified credit during lifetime, tax apportionment, etc.). He referred to PLR 199926019, which approved the split of a QTIP into two trusts, so that the spouse could make a nonqualified disclaimer from one of the trusts, and thus trigger gift tax under section 2519 only over the disclaimed trust. He urged drafters to include authority to make gifts in powers of attorney. Finally, he summarized the law governing completion of gifts made by checks that do not fully clear before death, and in that regard, he suggested that those gifts be made by bank checks, not by ordinary personal checks, to eliminate the Service's argument that the gift is not complete because of the donor's power to stop payment of the check.

Jerome Hesch: Jerry Hesch of Miami, Florida spoke on uses of deferred payment or installment sales in estate planning.

The problems of direct sales (recognition of gain, lack of basis adjustment for IRD items at death) can be avoided by sales to grantor trusts.

Jerry characterized as a "myth" the now-common folklore that there must be a 10% funding requirement for a grantor trust to purchase assets on an installment sale. He stated that nowhere in any published ruling, case, or other administrative pronouncement of the Service is there such a 10% rule. It has taken on an aura of authority because it is easy to understand, but he stated emphatically that it is only a myth, and not a requirement of the law. He stated that there must or should be some funding by the grantor under the Swanson case (not cited in his outline) to be a grantor trust, but the funding does not have to be 10% of the purchase price.

Permissible capital sources for an asset purchase are independent funds held in the trust (including funds gifted by the donor), cash flow from the asset purchased (100% bootstrap sales financed wholly from the asset purchased are legitimate and are effective both for income and transfer tax purposes), loans from third parties, and guarantees of beneficiaries. Jerry said that if you are concerned about the gift tax consequences of a guarantee by the beneficiary, the trust should pay a guaranty fee to the beneficiary. He stated in his outline that a guaranty fee of approximately 1.5% would seem appropriate if the assets purchased consist of marketable securities, and perhaps as much as 4.5% if the assets purchased consist of real estate or closely held business interests.

Jerry noted that the tax extenders legislation passed last year in Congress included a provision that prohibits accrual basis taxpayers from obtaining installment sale treatment under section 453. Jerry noted that the $5 million maximum limitation in section 453A (which requires interest payments on deferred capital gains tax) is applied to each taxpayer, and for this purpose, spouses are separate taxpayers, and the rule is applied on a calendar year basis. Thus by structuring sales with two spouses, and having separate transactions in different calendar years (such as in December and in January), the limit becomes $20 million.

Jerry stated that there are no cases dealing with the consequences of loss of grantor trust status before an installment obligation has been satisfied in full. It is his belief that because there is no deemed transfer of property to the grantor trust during life, the deemed transfer for income tax purposes can occur only at death. Because there is no rule that treats death as an event of realization, no gain can be realized on the loss of grantor status and deemed transfer that occurs at death. The installment obligation is included in the gross estate, is not IRD, and gets a basis adjustment equal to the outstanding and unpaid amount of the obligation remaining due at death. If no principal reductions have occurred during lifetime, the basis of the purchased asset will be for the full principal amount of the note. Jerry stated that the talk abounding in estate planning circles about realization of income on death comes from theories under section 752, which have no application here.

Jerry observed that it may be advantageous to do a private annuity sale for a healthy individual in some circumstances. The private annuity is not governed by the installment sale rules, and thus can be used to avoid the rules of section 453(e) which cause gain from an installment sale to be accelerated if the related party purchaser subsequently sells the asset within two years of the first installment sale. None of the other rules of section 453 will apply, and neither will the OID rules. The technique can work well on sales of large amounts for older clients.

That's it for Report #9.