TRANSFER TAX STRATEGIES FOR THE TECH ENTREPRENEUR

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I. BRIEF OVERVIEW OF THE POTENTIAL CLIENT

A. Common Themes When Advising the Tech Entrepreneur. While the tech industry involves a wide range of individuals with varying backgrounds and personalities, there are certain common themes noted by this panel as a result of our dealings with tech entrepreneurs.

1. Much like entrepreneurs in other sectors, tech entrepreneurs frequently seek out change through the creation of a new asset or venture, the pursuit of which requires a certain level of liquidity. As a result, this type of client will want to incorporate a need for liquidity into his or her estate plan and may be hesitant to give away control over certain assets.

2. Frequently, but not always, this type of client may be younger and/or unfamiliar with the use of legal services. In particular, such client may be new to estate planning, in general, and transfer tax planning, specifically. This type of client may also be much more interested in income tax planning, as the client is likely in the asset accumulation phase of his or her life.

3. This type of client may be under greater pressure to sell his or her business than those in other sectors, as intellectual property (“IP”) has a limited lifespan due to its limited period of legal protection and the pace of the tech market as a whole. As a result, such client may be hesitant to engage in planning that might dissuade a larger business (e.g., a larger tech company or venture capital firm) from viewing the client’s business as desirable target for purchase or investment.

B. Client Scenarios

1. Client scenario #1: Client owns IP that he or she believes will be worth $$$ in the future. The IP is not currently part of a functioning business.

2. Client scenario #2: Client has created a functioning business that utilizes certain items of IP also created by the client. Client believes that the business will be acquired in the future, with such acquisition resulting in a substantial spike in the business’s value.
II. POTENTIAL ASSETS AVAILABLE FOR TRANSFER

A. IP

1. Patent: A patent is a contract between the federal government and an inventor under which the government grants the inventor the right to exclude others from making, using, selling, offering for sale or importing an invention in or into the U.S. during the term of the patent. In exchange for this right, the inventor has to disclose to the public the details of the invention subject to the patent (i.e., how to create and use such invention). To seek a patent, an inventor must file a patent application with the U.S. Patent and Trademark Office.

Most patents are either utility patents or design patents.

a. A “utility patent” protects a new and useful method, process, machine, device, manufactured item or chemical compound or an improvement to any such invention. A utility patent lasts for 20 years from the earliest effective filing date.

b. A “design patent” protects any new, original and ornamental design of a manufactured item. A design patent lasts for 15 years from its issue date.

A patent is treated as personal property under state law and is assignable by an instrument in writing. However, any assignment will be void against a subsequent purchaser or mortgagee for valuable consideration unless it is recorded with the U.S. Patent and Trademark Office by the earlier of 3 months after the assignment’s date or prior to the subsequent purchase or mortgage. If the assignee will need to take any action in an application, patent or other patent proceeding, the assignment will also need to be made of record in the file of such proceeding.

2. Copyright: A copyright refers to the exclusive legal right to make, distribute, adapt, display or perform an original work of authorship that

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2 Id.
6 35 U.S.C. § 261. As assignment refers to the transfer to another of a party’s entire ownership interest in the patent or a percentage of the party’s entire ownership interest. That is, it must include the same percentage of the entirety of the bundle of rights that is associated with the party’s ownership interest. 37 C.F.R. § 3.1.
has been fixed to a tangible medium of expression.\textsuperscript{7} A copyright vests upon creation of the work, although an author may register a copyright with the U.S. Copyright Office to strengthen his or her rights and as a prerequisite to any legal action for copyright infringement.\textsuperscript{8} A copyright lasts for the author’s lifetime plus 70 years.\textsuperscript{9}

The author of the original work will be the copyright’s sole owner, with the exceptions of “work made for hire” and “joint work”\textsuperscript{10}

a. A work made for hire is (i) a work prepared by an employee within the scope of his or her employment or (ii) a work specially ordered or commissioned for use if the parties agree in a written instrument signed by them that the work will be considered a work made for hire.

b. A joint work is a work prepared by two or more authors with the intention that their contributions be merged into inseparable or interdependent parts of a unitary whole. Joint work is owned jointly by all creators. Each joint owner has the right to commercially exploit the entire copyright, provided that all joint owners must share equally in the resulting proceeds.

A transfer of copyright ownership must be reflected in “an instrument of conveyance, or a note or memorandum of the transfer” to be effective.\textsuperscript{11} A transfer may be recorded in the U.S. Copyright Office but this is not required for an effective transfer. If two conflicting transfers arise, the first to be executed has priority if it is recorded within a month of execution; otherwise, the first to be recorded will take priority if the transferee entered into the transaction in good faith, without notice of the other transfer and for consideration.\textsuperscript{12}

With the exception of works made for hire, the exclusive or nonexclusive grant of a transfer or license of a copyright or any right under a copyright executed on or after January 1, 1978, other than by Will, may be terminated by the grantor after 35 years, subject to certain exceptions for

\textsuperscript{7} 17 U.S.C. § 102.
\textsuperscript{8} 17 U.S.C. § 412.
\textsuperscript{9} 17 U.S.C. § 302(a).
\textsuperscript{10} 17 U.S.C. § 101.
\textsuperscript{11} 17 U.S.C. § 204. A “transfer of copyright ownership” is defined as “an assignment, mortgage, exclusive license, or any other conveyance, alienation or hypothecation of a copyright or any of the exclusive rights comprised in a copyright, whether or not it is limited in time or place of effect, but not including a nonexclusive license”. 17 U.S.C. § 101.
\textsuperscript{12} 17 U.S.C. § 205(d).
the transfer of a right to publish a copyright.\textsuperscript{13} If the work in question is a joint work, a majority of the grantors must join in the termination. If the grantor dies during this 35-year period, his or her termination right will pass to his or her surviving spouse and/or descendants, or, in the absence of both a surviving spouse and any descendants, to the personal representative of his or her estate. The right of termination may be exercised at any time during the 5 years following the end of the 35-year period. A terminating party must provide a signed, written notice of the termination’s effective date to the grantee not less than 2 or more than 10 years before such effective date. A copy of such notice must be filed with the U.S. Copyright Office prior to the termination’s effective date. The grantor’s termination right cannot be waived.

A copyright is treated as personal property for purposes of state law.

3. Trademark: A trademark is a symbol used in commerce to identify and distinguish the source of goods or services.\textsuperscript{14} Common law trademark protection is granted to the first party to use a trademark and is limited to the geographic area in which the trademark is used. Additionally, a trademark may be registered with the U.S. Patent Trademark Office under the Lanham Act for a 10-year period of protection under federal law and additional 10-year renewal periods.\textsuperscript{15}

A trademark may only be assigned to another party in writing with the goodwill of the business in which the mark is used and any assignment should be filed with the U.S. Patent Trademark Office for protection under federal law.\textsuperscript{16} Additionally, an intent-to-use application cannot be assigned prior to the filing of a Statement of Use or an Amendment to Allege Use, unless the assignment is to a successor to the applicant’s business or the portion of such business to which the mark pertains.

4. Trade Secret: A trade secret is a piece of information that derives economic value from not being generally known or readily ascertainable by those that could gain value from its use and that is subject to certain

\textsuperscript{13} 17 U.S.C. § 203. For our purposes, we will not consider the contingent termination rights that federal law grants a transferor’s heirs upon a transfer of copyright ownership as taxable gifts from the transferor to such heirs, due to the lack of voluntariness in the creation of such rights on the part of the transferor. For an article arguing otherwise, see Bridget J. Crawford and Mitchell M. Gans, “Sticky Copyrights: Discriminatory Tax Restraints on the Transfer of IP”, 67 Wash & Lee L. Rev. 25, Winter, 2010.

\textsuperscript{14} 15 U.S.C. § 1127.

\textsuperscript{15} 15 U.S.C. §§ 1051, 1058 and 1059.

measures to maintain its confidentiality. Rather than granting an owner an exclusive right to public use, trade secret protection seeks to prevent wrongful access to confidential information.

In order to transfer the value of a trade secret to another party, the current owner must expressly authorize use of the trade secret by the recipient and both parties must ensure the information’s continued confidentiality. Trade secrets can receive indefinite protection if the trade secret continues to have economic value, remains secret and reasonable security measures continue to be taken.

5. Note on ownership: you must determine if the client truly owns the IP in question!

B. Entity Interests

1. Entity Choice: Tech entrepreneurs often consider whether they should form their business as a limited liability company (an “LLC”) or as a corporation. There is a rarely a “one size fits all” answer to the question of what type of entity to form and an entrepreneur’s business and financial advisors (i.e., his or her accountant, corporate attorney, etc.) should examine many criteria in assisting with this decision, including tax implications and the client’s short and long-term goals.

2. Transfer Restrictions: A planner considering the transfer of an entity interest should review such entity’s organizational documents for any applicable transfer restrictions. Such restrictions are likely to be found in the Operating Agreement of an LLC or the Bylaws or Shareholders’ Agreement of a corporation. Examples of such provisions include:

   a. “Right of First Refusal”, under which an owner who has received an offer to sell his or her ownership interest to a third party must first offer to sell such interest to the entity’s other owners under the same terms.

   b. “Right of First Offer”, under which an owner seeking to sell his or her ownership interest under certain terms must first offer the entity’s other owners the opportunity to purchase such interest

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17 18 U.S.C. § 1839(3). Until 2016, trade secret protection was available almost exclusively under state law. The Uniform Trade Secret Act has been adopted in all U.S. states and the District of Columbia other than New York and North Carolina, although North Carolina has adopted many of its provisions.

18 Special consideration is often given to the state or other jurisdiction in which to form such entity and whether the entity needs to register to do business in other jurisdictions. A planner contemplating a transfer of an entity interest should consider the implications under the laws of all applicable jurisdictions.
under the suggested terms before offering the same terms to a third-party purchaser.

c. “Death Buy-Out”, under which either the entity may redeem or the other entity owners may purchase the ownership interest at a set price at an owner’s death.

d. “Drag-Along Provision”, under which the owner of a minority interest in an entity may be forced to sell his or her interest to the same purchaser and under the same terms as those involved in a majority interest owner’s sale of his or her interest.

e. “Tag-Along Provision”, under which the owner of a minority interest in an entity may elect to sell his or her interest to the same purchaser and under the same terms as those involved in a majority interest owner’s sale of his or her interest.

3. S Corporations: If the business is structured as an LLC or corporation that has elected to be treated as an “S corporation” for tax purposes, it is important to remember the following:

a. An S corporation can have no more than 100 shareholders. However, an individual and his or her spouse (and their estates) may be treated as one shareholder for purposes of this rule. Additionally, all members of a family (and their estates) can be treated as one shareholder.19

b. Only individuals, estates, certain exempt organizations described in IRC § 401(a) or 501(c)(3) or certain trusts described in IRC § 1361(c)(2)(A) (qualified subchapter S trusts and electing small business trusts) are permissible shareholders. Additionally, a nonresident alien cannot be a direct shareholder.

4. Securities Law Considerations.20

a. Under the Securities Act of 1933 (the “Securities Act”)21, every offer and sale of a security must either be registered with the Securities and Exchange Commission or subject to an exemption from

19 IRC § 1361. References to the “IRC §” refer to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise noted. References to “Treas. Reg. §” refer to sections of the regulations promulgated by the Treasury Department under the Code (the “Regulations”).

20 In addition to federal securities laws, a planner considering the sale of a security should review the applicable state’s securities laws (frequently referred to as “blue sky laws”).

registration under the Securities Act. This includes an offer and sale to friends, family or a trust or other entity and also applies when offering equity to employees, consultants, etc. The Securities Act does not regulate a gift of a security.

b. The Securities Act defines a “security” as “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing”.  


24 15 U.S.C. § 77d(a)(2). This section of the Securities Act merely provides that such Act’s restrictions do not apply to “transactions by an issuer not involved in a public offering”.

c. To register a business’s securities, a business must file a registration statement with the Securities and Exchange Commission. Once the Securities and Exchange Commission declares that the registration is effective, the business may begin to sell its securities publicly. As registration is both burdensome and expensive, most small businesses look to qualify for an exception from registration.

d. Section 4(a)(2) of the Securities Act provides a “private placement exemption”. However, the specifics of this exemption are not defined under the Securities Act. Rather, the considerations in determining whether an offering qualifies for the private placement exemption have been established under case law. For example, in SEC v. Ralston Purina Co., the Supreme Court held that an offering to purchasers who could “fend for themselves” was exempt as a private placement and, in evaluating the nature of
potential purchasers, courts should look to whether the purchaser had sufficient access to the types of information registration would disclose and was financially sophisticated.25

e. Rules 506(b) and (c) of “Regulation D” under the Securities Act provide “safe-harbors” under the private placement exemption.26

i. Rule 506(b) provides a safe harbor for businesses seeking to raise unlimited money in private offerings if certain requirements are met, including a ban on the use of general solicitation or advertising to market the securities, the sale of the securities to an unlimited number of “accredited investors” and related purchasers and no more than 35 other purchasers, making certain information available to the investors (including all information that would typically appear on a registration statement if non-accredited investors are involved), and ensuring that knowledgeable persons are available to answer questions of prospective purchasers.27

ii. Rule 506(c) provides a safe harbor for a business seeking to solicit and advertise the offering if all the investors qualify as accredited investors and the business has taken reasonable steps to confirm such status.28

iii. Under both Rule 506(b) and 506(c), the securities purchased may not be resold for at least 6 months or a year without registering them.29

iv. An “accredited investor” includes (i) any individual that earned income in excess of $200,000 (or $300,000 with a spouse) in each of the prior 2 years and reasonably expects the same for the current year, or has a net worth of over $1 million (either alone or with a spouse), excluding the value of the investor’s primary residence, (ii) certain entities that are required to have assets in excess of $5 million or have equity owners that are all accredited investors, and (iii) any trust, with total assets in excess of $5 million, not formed to specifically purchase the subject securities, whose purchase

26 17 C.F.R. § 230.506.
28 17 C.F.R. § 230.506.
is directed by a sophisticated person. Additionally, a revocable trust may be an accredited investor if its grantor is an accredited investor.

III. INCOME TAX ISSUES

A. IP

1. Licensing: An IP license is a contract between two parties for the use of some or all of the licensor’s IP in exchange for consideration (e.g., a lump sum payment, multiple payments, a royalty stream, etc.). The payments made under a license may be fixed to the sale of related goods or services.

   a. Exclusive license: An exclusive license is similar to an assignment in that the licensor grants the licensee the use of substantially all of the licensor’s rights in the subject property (i.e., the exclusive right to make, use or sell for the life of the property). For income tax purposes, the grant of an exclusive license is treated as a sale of the subject property and the licensor is entitled to recover any basis in the property.

   b. Non-exclusive license: Under a non-exclusive license, the licensor grants the licensee less than substantially all of the licensor’s rights (e.g., a license for less than the property’s life, a license that grants the right to make and sell but not use the property, etc.). For income tax purposes, a non-exclusive license is treated as a license that generates royalty income and the licensor cannot recover any basis in the asset. Royalty income is subject to tax at ordinary income tax rates.

2. Sale

   a. IRC § 1221(a) excludes from the definition of a capital asset stock-in-trade, inventory and property held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business.

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30 17 C.F.R. § 230.501(a).
33 See Waterman v. Mackenzie, 138 U.S. 252 (1891) (the grant of an exclusive right to make and sell a patented machine but not the right to use such machine is a license, not a sale).
34 IRC § 61(a)(6); Treas. Reg. § 1.61-8.
Thus, the IP associated with a professional inventor’s inventions may be barred from capital asset treatment under IRC § 1221(a).\textsuperscript{35}

b. IRC § 1221(a)(2) excludes from the definition of a capital asset depreciable property used in a taxpayer’s trade or business. This includes separately acquired patents, copyrights and computer software and other IRC § 197 intangible assets (including trademarks).

c. IRC § 1221(a)(3) excludes from the definition of a capital asset various forms of IP, including a patent, invention, model or design (whether or not patented), a secret formula or process and a copyright, if held by the creator of such property or a taxpayer in whose hands the basis of such property is determined in whole or in part by reference to the creator’s basis (i.e., the donee of a gift of such asset).\textsuperscript{36} Thus, a gift for estate tax planning purposes will extend the ordinary income tax treatment imposed under IRC § 1221(a)(3). Conversely, the sale of the asset will give the purchaser a cost basis therein and the ability to qualify for capital asset treatment in the future. If an individual inherits IP as part of the creator’s taxable estate, the individual will receive the property with a stepped-up fair market value basis\textsuperscript{37} and such asset will automatically qualify as a capital asset that has been held for over 1 year.\textsuperscript{38}

d. IRC § 1235 provides that a transfer (other than by gift, inheritance or devise) of property consisting of all substantial rights\textsuperscript{39} to a patent (or an undivided interest in all such rights) by a holder will be treated as the sale or exchange of a capital asset held for more than 1 year, regardless of whether payments in consideration for such transfer are made over the transferee’s period of use or contingent upon the productivity, use, or disposition of the property.\textsuperscript{40} However, IRC § 1235(c) provides that capital asset treatment does not extend to a transfer, directly or indirectly, between persons specified in IRC § 267(b) or 707(b), subject to

\textsuperscript{35} See Lockhart v. Comm’r, 258 F.2d 343 (3d Cir. 1958) (grant of 37 patents over 19-year period supported finding that inventor was in the business of selling patents and could not treat any such patent as a capital asset).

\textsuperscript{36} Prior to the 2017 Tax Cuts and Jobs Act, patents were excluded from this list.

\textsuperscript{37} IRC § 1014.

\textsuperscript{38} IRC § 1223(9).

\textsuperscript{39} Treas. Reg. § 1.1235-2(b)(1) provides examples of transfers that fail this “all substantial rights” requirement.

\textsuperscript{40} But note the possible impact of IRC § 1245 as it requires that gain recognized on the disposition of intangible property must be reported as ordinary income to the extent of depreciation or amortization deductions taken with respect to such property.
certain exceptions. Thus, for example, any gain recognized on a
transfer between the creator of the patent and a trust of which the
creator is a grantor will be taxed as ordinary income.\textsuperscript{41}

A holder is defined as an individual who either (i) created the
patent\textsuperscript{42} or (ii) acquired the patent for money or money’s worth
prior to reduction to practice of the invention covered by the
patent and who is neither the creator’s employer nor a person
related to the creator at the time the rights are acquired.\textsuperscript{43}
Although a partnership cannot be a holder, each partner of the
partnership who is an individual may qualify as a holder as to his
share of a patent owned by the partnership.\textsuperscript{44}

e. In additions to the restrictions on capital asset treatment for
trademarks under IRC § 1221(a)(2), IRC § 1253 imposes ordinary
income treatment on all payments for the sale of a trademark that
are contingent on the productivity, use, or disposition of a
trademark or trade name.\textsuperscript{45} Additionally, noncontingent payments
will be subject to ordinary income tax rates if the transferor retains
any significant power, right or continuing interest with respect to
the subject matter of the mark or name.

3. Donation to Charity.

a. IRC § 170(e)(1)(B)(iii) provides that the charitable deduction
generated by the contribution of IP is limited to the lesser of the
property’s fair market value or the donor’s adjusted basis. Many
owners of IP have little to no basis in such property due to prior
deductions under IRC §§ 162 (business expenses), 174 (research
expenditures) and 197 (amortization). Thus, this cost basis
limitation may discourage the donation of income-producing IP.

\textsuperscript{41} A grantor and a fiduciary of any trust are considered related parties for purposes of IRC § 267(b) and, thus, IRC § 1235. Treas. Reg. § 1.1235-2(f)(4). Additionally, note that the reference to a direct or indirect transfer may substantially expand the category of related parties under prior case law decided under IRC § 276(b). See Barnes v. U.S., 222 F. Supp. 960 (D. Mass 1963) (sale of trust property by trustee to spouse of beneficiary was deemed indirect sale to beneficiary).

\textsuperscript{42} As the grantor of a “grantor trust” under IRC §§ 671-679 is treated as the owner of such trust’s assets for income
tax purposes, the grantor trust of a creator of IP should be a qualified holder for purposes of IRC § 1235. However,
see PLR 200219017 (where trust in question would have qualified as grantor trust as to various contributors, IRS
relied on definition of “trust” found in Treas. Reg. § 301.7701-4 to determine whether a trust was an ordinary trust
or could be treated as a partnership for purposes of IRC § 1235).

\textsuperscript{43} Related persons are defined pursuant to IRC § 267(b) (i.e., the holder’s spouse, ancestors and lineal descendants)
but exclude the holder’s brothers and sisters.

\textsuperscript{44} Treas. Reg. § 1.1235-2.

\textsuperscript{45} See IRC § 1253(b)(2) for examples of potentially significant powers.
b. To remedy such discouragement, Congress adopted IRC § 170(m), which permits the donor of IP to a charity (other than a private non-operating foundation) to recognize an additional charitable deduction in each of the 10 years following the original donation, subject to a sliding percentage scale.

c. This provision applies only to “qualified intellectual property”, defined as: (i) patent, (ii) copyright (other than as described in Section 1221(a)(3) or 1231(b)(1)(C))\(^{46}\), (iii) trademark, (iv) trade name, (v) trade secret, (vi) know-how, (vii) software (other than as described in IRC § 197(e)(3)(A)(i))\(^{47}\), and (ix) similar property and applications or registrations of such property.

i. To be eligible for such future deductions, the donor must provide notice to the donee organization at the time of the contribution that includes: (A) the name, address and taxpayer identification number of the donor; (B) a description of the qualified IP in sufficient detail to identify the property; (C) the date of contribution; and (D) a statement that the donor intends to treat the contribution as a qualified IP contribution for purposes of IRC §§ 170(m) and 6050L.\(^{48}\)

ii. The donee organization must file a Form 8899 30 days after the end of each of the donee’s tax years in which the donee receives or accrues net income from the property.\(^{49}\) However, the donee organization is not required to file a Form 8899 for any year after the property’s legal life has ended.

iii. The donor’s additional deduction is calculated by multiplying the donee’s net income from the qualified intellectual property by that year’s applicable percentage, provided that such deduction is allowed only after the aggregate amount of net income from the property, as

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\(^{46}\) A copyright described in IRC § 1221(a)(3) or 1231(b)(1)(C) refers to a copyright held by a taxpayer whose personal efforts created the property or whose basis in the property is determined, in part or whole, on the basis of the taxpayer whose personal efforts created the property.

\(^{47}\) Software described in IRC § 197(e)(3)(A)(i) refers to software readily available for purchase by the general public, subject to a nonexclusive license, that has not been substantially modified.

\(^{48}\) IRC 170(m)(8); IRS Notice 2005-41, 2005-1, CB 1203.

\(^{49}\) IRS Form 8899.
adjusted by the annual percentage limitations, exceeds the amount of any deduction allowed at the initial contribution.

B. **Entity Interests**

1. **Funding of Entity with IP:** IRC § 351(a) provides that no gain or loss will be recognized on the contribution of property to a corporation solely in exchange for stock in such corporation, if the transferor is immediately thereafter in control of the corporation (as defined in IRC § 368(c)). Similarly, IRC § 721 provides that no gain or loss will be recognized to either a partnership or any of its partners upon a contribution of property to a partnership in exchange for a partnership interest. Generally, the taxpayer then takes such stock or partnership interest with the same basis that the taxpayer had in the contributed IP, with the taxpayer’s previous holding period in the IP “tacked” on to the taxpayer’s actual holding period of the stock or partnership interest for purposes of long-term capital gain treatment.

2. **Capital Gain vs Ordinary Income:** Entities created by tech entrepreneurs are subject to the normal rules regarding capital gain versus ordinary income, an overview of which is beyond the scope of this outline. However, IRC § 1202 provides a special exception to these rules that may be of great value to a tech entrepreneur with qualified small business stock (“QSBS”).

   a. IRC § 1202 provides that a portion or all of the gain from the sale or exchange of QSBS that has been held for 5 years will be excluded from a taxpayer’s gross income. The percentage of gain that can be excluded is determined based on the year the QSBS was acquired, with 100% exclusion for QSBS acquired after September 27, 2010. Any gain that is not excluded due to the per issuer limitations in place (described below) will be subject to a 28% maximum capital gain rate, plus the 3.8% Medicare surtax.

   b. The gain to which IRC § 1202 is applied is capped at the greater of (i) $10 million reduced by the aggregate amount of eligible gain

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50 IRC §§ 358, 722 and 1223(1). Note however that, for purposes of IRC § 1202, the holding period will begin on the date of exchange, rather than allowing for a tacking of the ownership period prior to the exchange.

51 The taxpayer may not be a corporation in order to take advantage of IRC § 1202. IRC § 1202(a)(1).

52 QSBS acquired after August 9, 1993 and before February 18, 2009 is eligible for a 50% exclusion. QSBS acquired from February 18, 2009 through September 27, 2010 is eligible for a 75% exclusion. QSBS acquired on or after September 28, 2010 is eligible for a 100% exclusion. QSBS acquired prior to September 28, 2010 is subject to the inclusion of 7% of any excluded gain in the taxpayer’s alternative minimum tax (AMT) computation. IRC § 57(a)(7). Such inclusion does not apply to QSBS acquired on or after September 28, 2010.

53 IRC §§ 1(h)(7) and 1411.
taken into account by the taxpayer for prior taxable years and attributable to dispositions of stock issued by such corporation (i.e., a cumulative limitation) or (ii) 10 times the aggregate adjusted bases of QSBS issued by such corporation and disposed of by the taxpayer in that same tax year (i.e., an annual limitation). Note that this cap is calculated each time that a taxpayer sells QSBS from the same corporation. Thus, for example, if a taxpayer has taken advantage of the entire $10 million exclusion amount under the cumulative limitation, he or she may continue to exclude eligible gain up to the annual limitation amount in future years.

c. If QSBS is transferred by gift, by death or from a partnership to one of its partners, the term of the prior holder’s ownership may be tacked to the transferee’s holding period.

d. For stock to qualify for QSBS treatment:

i. The subject stock must be stock of a C corporation at the date of issuance and must be issued after August 10, 1993.

ii. The subject corporation must have aggregate gross assets of no more than $50 million (A) at all times after August 10, 1993 and through the date of issuance and (B) immediately after the stock issuance. “Aggregate gross assets” refers to the corporation’s cash plus the aggregate adjusted bases of the corporation’s other property. Thus, the corporation can hold low-basis IP with significant fair market value without exceeding the $50 million limit. However, for purposes of IRC § 1202, the adjusted basis of property contributed to a corporation is equal to its fair market value on the date of contribution so low basis assets must appreciate within the corporation to provide this benefit.

54 Interesting amplification strategies under IRC § 1202 include “stacking” (i.e., transferring by gift stock to multiple irrevocable non-grantor trusts each of which will be entitled to its own exclusion amount) and “packing” (i.e., selling high-basis stock in a corporation, including that which has not been held for 5 years and, thus, does not trigger eligible gain, in order to increase the aggregate adjusted bases disposed of by the taxpayer in that tax year). See Paul S. Lee, “Qualified Small Business Stock: The Next Big Bang”, Heckerling Institute, January 2019.

55 IRC § 1202(h).

56 IRC § 1202(c).

57 IRC § 1202(d)(1).

58 IRC § 1202(d)(2).

59 IRC § 1202(i)(1)(B).
iii. The subject stock must be acquired by the taxpayer at “original issuance”. This generally means that the taxpayer must acquire the stock directly from the issuing corporation in exchange for money or other property (other than stock) or as compensation for services provided to the corporation (other than services performed as an underwriter). Additionally, stock acquired through a gift, at death or as a distribution from a partnership will be treated as having been received by the transferee in the same manner as the transferor received such stock.

A. Stock issued in exchange for contributed property will be treated as acquired on the date of contribution.

B. Stock transferred via gift, at death or by a partnership will be treated as acquired on the date the transferor originally acquired such stock.

iv. The issuing corporation must have been a C corporation and meet certain “active business” requirements for substantially all of the taxpayer’s holding period. Note, however, that neither IRC § 1202 nor the underlying Regulations define the term “substantially all”.

A. This means that, in addition to the corporation being a C corporation on the date of issuance, it must remain a C corporation for the majority of the taxpayer’s holding period.

B. The active business requirement requires that the corporation be an eligible corporation (i.e., a domestic corporation, other than a DISC or former DISC, a regulated investment company, real estate...
investment trust, REMIC or a cooperative) and at least 80% of the corporation’s assets must be used in the active conduct of one or more qualified trades or businesses (i.e., a trade or business other than certain disqualified trades or businesses, including those where the principal asset is the principal’s reputation or skill, certain banking or financial businesses, etc.). The 80% test is based on the fair market value, not the adjusted bases, of the corporation’s assets. A corporation will be deemed to own its ratable share of the assets of any subsidiary corporation (i.e., any other corporation in which the parent corporation owns 50% or more of the stock) and to conduct its ratable share of the subsidiary’s activities for purposes of the 80% test.

To the extent the corporation owns a portfolio of stock or securities, it will fail the 80% test if more than 10% of its net asset value consists of stock in other non-subsidiary corporations. Additionally, a corporation will fail the 80% test if more than 10% of the total value of its assets consists of real property not used in the active conduct of a qualified trade or business. For these purposes, ownership of, dealing in or renting real property are not treated as the active conduct of a qualified trade or business. Assets held as part of the “reasonably required working capital needs” of a qualified trade or business, or held for investment and that are reasonably expected to be used within 2 years to finance research or experimentation in a qualified trade or business or increases in the working capital needs of a qualified trade or business, are treated as used in the active conduct of a qualified trade or business. However, a corporation cannot rely on the exception for funds held for investment or future costs or capital needs with respect to more than 50% of the corporation’s assets for any period after the corporation’s first 2 years of existence.

Rights to computer software that produce active

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65 IRC § 1202(e).
66 IRC § 1202(e)(5).
67 Id.
68 IRC § 1202(e)(7).
69 IRC § 1202(e)(6).
business computer software royalties (as defined in IRC § 543(d)(1)) will be treated as an asset used in an active trade or business for purposes of the 80% test.\textsuperscript{70}

e. IRC § 1202 will not apply to corporate gain recognized from the sale of a corporation’s assets. However, if the corporation then liquidates and distributes the proceeds to its shareholders, presumably, the shareholders can use IRC § 1202 to exclude gain on the distributions.\textsuperscript{71} A taxpayer who sells his or her stock in a redemption should also qualify for IRC § 1202 treatment, subject to certain restrictions.\textsuperscript{72}

f. IRC § 1045 allows a taxpayer to avoid recognition of gain on the sale of QSBS if the taxpayer reinvests the sale proceeds into new QSBS within 60 days from the date of sale. To qualify for this treatment the taxpayer must have held the QSBS for more than 6 months and the taxpayer must elect to apply the rollover provisions of IRC § 1045 on the taxpayer’s income tax return in the year in which the QSBS is sold.\textsuperscript{73} The basis of the purchased stock will be reduced by the amount of gain that was not recognized on the stock’s purchase due to the IRC § 1045 rollover election.\textsuperscript{74} The purchased stock is determined to be QSBS based on whether it meets the definition under IRC § 1202(c) during the first 6 months following its purchase.\textsuperscript{75}

3. Donation to Charity.

a. Generally, the contributor of an entity interest can recognize a charitable deduction for such contribution (subject to any applicable percentage limitations) equal to the interest’s fair market value, reduced by the value of any gain that would not be recognized as long-term capital gain if the interest were then sold at its fair market value.\textsuperscript{76} However, if the donee is a private non-operating foundation, the deduction must also be reduced by the value of any gain that \textit{would} be recognized as long-term capital gain,\textsuperscript{70} IRC § 1202(e)(8).

\textsuperscript{71} IRC § 331 (which provides that distributions made to shareholders in the context of a complete corporate liquidation are to be treated as full payment in exchange for stock).

\textsuperscript{72} IRC § 1202(c)(3).

\textsuperscript{73} IRC § 1045(a); Rev. Proc. 98-48, 1998-2 CB 367.

\textsuperscript{74} IRC § 1045(b)(3).

\textsuperscript{75} IRC § 1045(b)(4)(B).

\textsuperscript{76} IRC § 170(e)(1)(A).
with an exception for qualified appreciated stock (i.e., publicly-traded stock).\textsuperscript{77}

b. IRC § 751 further reduces the deduction resulting from the contribution of a partnership interest.\textsuperscript{78} Under IRC § 751, if a partnership interest were sold, the amount of sale proceeds received in exchange for any portion of the partnership interest attributable to the partnership’s unrealized receivables or inventory assets would be considered an amount realized in exchange for a non-capital asset. Thus, under IRC § 170(e)(1)(A), the resulting deduction would be reduced by this amount.

c. With respect to a partnership with liabilities, the taxpayer’s share of such liabilities will trigger “bargain sale” status for the contribution (i.e., the contribution will be treated as a part-sale and a part-gift).\textsuperscript{79} IRC § 1011(b) provides that the taxpayer’s basis in the contributed property for purposes of determining the appropriate charitable deduction will be allocated between the sale and gift portions of such transaction in the same percentage as the amount realized bears to the property’s fair market value at the time of transfer.

d. Under IRC § 512(e), if a charity is a shareholder in an S corporation, such interest will be treated as an interest in an unrelated trade or business and all items of income and gain allocable to the charity will constitute unrelated business taxable income (“UBTI”). As such, if a taxpayer wishes to contribute S corporation stock to a charity, the charity may want assurances that the corporation will make sufficient distributions to the charity to pay any resulting tax liability.

e. The taxpayer should also consider the effect of the excess business holdings rule under IRC § 4943 if contemplating the contribution of an entity interest to a private foundation or a donor-advised fund. Generally, this rule imposes a tax on a foundation or fund if such entity and its disqualified persons (e.g., substantial contributors, directors, officers and their family members, etc.) own, in the

\textsuperscript{77} IRC §§ 170(e)(1)(B)(ii) and 170(e)(5)(A).

\textsuperscript{78} IRC § 170(e)(1) provides that “rules similar to the rules of section 751” will apply in determining whether gain on the sale of S corporation stock would be deemed long-term capital gain for purposes of determining the charitable deduction for the contribution of such stock.

\textsuperscript{79} Treas. Reg. § 1.1011-2(a)(3) provides that, if indebted property is transferred to a charity, the amount of such debt must be treated as an amount realized for purposes of determining if a portion of the contribution will be treated as a sale under IRC § 1011(b), even if the charity does not assume the liability.
aggregate, more than 20% of an active trade or business. The tax imposed equals 10% of the value of any interest in an active trade or business owned by the foundation or fund in excess of this 20% cutoff, with a potential to increase to 200% of such value if the foundation or fund does not reduce its holdings to permissible levels within a certain time period. Note, however, that there are several exceptions to this rule, including (i) an exception for any foundation or fund that owns 2% or less of an active business (both as to voting and value), regardless of any ownership by disqualified persons, and (ii) an increase of the 20% cutoff to 35% if the foundation or fund can demonstrate that the business is effectively controlled by third parties who are not disqualified persons.

IV. VALUATION ISSUES

A. IP

1. Cost Approach:

   a. Reproduction method: Estimate cost to reproduce an exact replica of the property using the same design, standards and materials.

   b. Replacement method: Estimate cost to replace the property with other property that has the same functionality. This method is the more useful of the two cost approaches in that a buyer would likely pay only what it would cost to replicate the functionality of the property in question.

2. Market Approach:

   a. Sales transaction method: Estimate value based on actual market transactions/sales of comparable or guideline property in arms-length transactions.

   b. Relief from royalty method: Estimate value based on the cost saved by owning the property rather than licensing it, based on licensing transactions for property with similar risk and investment return profiles.

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80 IRC §§ 4943(a) and (c).
81 IRC §§ 4943(a)(1) and (b).
82 IRC § 4943(c)(2).
3. **Income Approach:**
   a. Discounted cash flow method: Estimate value based on the present value of the expected cash flow associated with ownership and use of the property, with an adjustment to allocate a portion of the cash flow to the company’s other property.
   
   b. Comparative income differential method: Estimate value by comparing the income generated with and without the use of the subject property.
   
   c. Monte Carlo method: Estimate key variables within certain ranges of outcomes and with related probabilities.
   
   d. Real Options method: Evaluate risks and returns in increments.

4. **Note on Copyrights:** As a copyright termination right does not constitute a “qualified interest” for purposes of IRC §2702, such termination rights will have no value in determining the gift tax value of a transfer in trust to or for the benefit of a member of the transferor’s family.

B. **Entity Interest**

1. **Cost or Asset-Based Approach**
   a. Under this approach, all of the company’s assets and liabilities are analyzed and valued separately, excluding goodwill.
   
   b. A market or risk adjusted income approach will likely produce a more accurate value for a technology company due to the assets generating such company’s value (e.g., patents, in-process research and development, goodwill, etc.).

2. **Income Approach**
   a. Under this approach, a value can be determined by (i) capitalizing the historical earnings of a company or (ii) discounting future earnings or cash flows (“DCF”) of a company.
   
   b. The DCF approach assumes that the value of a company equals the sum of the present value of future net cash flows and the present value of a terminal or residual value (i.e., the value of the future cash flows at the end of a projected period). The present value of
both future net cash flows and the terminal or residual value is determined by applying an appropriate discount rate. This discount rate reflects the percentages of total debt and equity to capital and the rate of return that would be required by an investor based on the investment’s risk level.

c. The historical earnings for technology companies may not accurately predict the company’s future earnings, as such companies often incur large expenses in the earlier development stages and grow rapidly after product commercialization.

5. Market Approach

a. There are typically two primary market methods: the guideline public company method and the guideline company transaction method.

b. The guideline public company method derives valuation multiples from the traded prices of public companies comparable to the subject company and then applies the selected multiple to the subject company’s appropriate benefit streams. Adjustments are then made to account for marketability and control differences.

c. The guideline company transaction method derives valuation multiples from the acquisition prices of public or private companies comparable to the subject company and then applies the selected multiple to the subject company’s appropriate benefit streams.

6. Notes About Tech Startups

a. These companies tend to lack an operating and financial history, their product or market may be novel or unpredictable, and their value tends to be based primarily on intellectual property, a quickly changing marketplace and ease of access to capital.

b. Given the uniqueness of these businesses, some non-traditional methods worth considering are:

i. Determining value by comparing the stage of a company as to its product development and time to revenues to other early stage companies.

ii. Look to average dilution for early stage investment by subtracting new funding from post-money valuation
(estimated based on the amount of funds raised divided by the dilution percentage).

iii. Look to prior round financing if no significant events have occurred since the last funding.

c. As capital is often raised for technology startups by issuing common stock, preferred stock, convertible debt, options and warrants, additional allocation methodologies would need to be applied to the company’s overall value to determine the value of any individual’s interest in the company.

i. Current value method ("CVM" or “Waterfall”): assumes an immediate sale of the enterprise and allocates that value to the various series of preferred stock based on the series’ liquidation preferences or conversion values, whichever would be greater.

ii. Probability Weighted Expected Return Method ("PWERM"): share value is based upon the probability-weighted present value of expected future investment returns, considering each of the possible future outcomes available to the enterprise, as well as the rights of each share class.

iii. Option Pricing Method ("OPM"): treats common stock and preferred stock as call options on the enterprise’s equity value, with exercise prices based on the liquidation preferences of the preferred stock.

7. Minority Interest Discounts

a. Downward adjustments may be applied to account for the lack of control or lack of marketability inherent in the subject interest.

i. Discount for lack of control ("DLOC").

ii. Discount for lack of marketability ("DLOM").

b. Discounts require appraiser judgment and consider the following:

i. Quantitative analysis such as put option calculations.

ii. Qualitative analysis that considers factors specific to the subject interest.
V. NON-CHARITABLE TRANSFER TAX STRATEGIES

A. IP

1. Patents: As patents have a lifespan of 20 years or less, there will likely be less concern about losing a step-up in basis at the owner’s death if the asset is transferred out of the owner’s taxable estate during life, unless the owner is expected to die during the patent’s legal lifespan. To exclude the any appreciation in the patent’s value from the owner’s taxable estate, the patent could be transferred to an irrevocable trust through either a sale or gift transaction. However, some thought should be given to the effect such transfer may have on the income tax treatment of the patent, as a gift of the patent or the sale of the patent to a related party will prevent the patent from being treated as a capital asset under IRC § 1235 in the event of a later sale.

a. If the trust’s grantor does not intend to grant an exclusive license of or sell the patent in the future, the patent could be sold to an intentionally defective grantor trust in exchange for a promissory note bearing interest at an applicable federal rate or higher without concern as to the income tax effects of such sale. Due to the trust’s grantor status, the sale would be treated as a sale by and to the grantor and, thus, no gain would be recognized on the original sale and interest paid on the promissory note. The trust can use the royalty income from the patent to make payments on the promissory note and the grantor can pay any income tax liability generated by the trust’s assets without the grantor being deemed to have made an additional taxable gift to the trust’s beneficiaries. The grantor can also allocate generation-skipping transfer (“GST”) tax to the trust, although the fact that the patent is a wasting asset should be considered. If there is uncertainty regarding the patent’s ability to generate royalty income, a gift to an intentionally defective grantor trust will also serve to decrease the size of the grantor’s estate, although it will require the grantor to utilize a small portion of his or her gift tax exemption.

If the grantor is open to the possibility of an exclusive license or sale of the patent in the future, the grantor should be given the ability to substitute the patent for a promissory note of an equivalent present value. This will both trigger grantor trust status and allow the grantor to regain ownership of the patent while retaining the transfer tax savings created by the trust’s original funding. As there is no requirement under IRC § 1235 that the
creator of a patent retain ownership of such asset throughout its lifespan in order to qualify for capital asset treatment, such substitution should allow the grantor to repossess the patent just in time to pay tax on the patent’s sale at the lower long-term capital gain tax rates and use the sale proceeds to pay back the promissory note given to the trust.

b. The client could also make a gift of the patent to a grantor retained annuity trust (a “GRAT”) to pass any appreciation in its value to the trust’s remainder beneficiaries free of transfer tax. For this strategy to succeed, it’s helpful if the GRAT is created in a low-interest rate environment. Additionally, the patent must be capable of generating sufficient income to pay the grantor a fixed annuity for a set number of years. GRAT terms typically range from 2 to 10 years. At the end of the GRAT term, the patent would transfer to the designated remainder beneficiaries. A GRAT may be structured so that the value of the initial gift is $0. This is not an ideal means of transferring wealth to later generations as the transferor cannot allocate his or her GST tax exemption to the trust’s assets until after the GRAT term has ended. If the client wishes to retain IRC § 1235 capital asset treatment, the remainder beneficiary should be structured as a grantor trust that allows the grantor a power of substitution over the patent.

2. Copyrights: Unlike patents, copyrights must necessarily survive their creators and, thus, a planner may want to seriously consider keeping a copyright in the author’s taxable estate in order to generate a step-up in basis and automatic capital asset treatment. This is especially true as the only way to transfer a copyright without triggering termination rights in the transferor and, potentially, his or her heirs, is under the transferor’s Will.

a. To reduce the estate tax owed on the value of a copyright held at death, an owner may wish to consider charitable planning of the sort described below. Additionally, an owner may consider using the copyright as collateral for a loan, the proceeds of which can be used for transfer tax planning, with such liability reducing the value of the owner’s taxable estate at his or her death.

b. If an owner wishes to pursue a lifetime transfer, the copyright should be sold to an irrevocable trust to avoid potential estate inclusion issues under IRC §§ 2036 and 2037, resulting from the creation of automatic termination rights under federal law. As described above, the owner could sell the copyright to a grantor
trust to avoid recognition of gain on the initial sale and any interest payments under a related promissory note. The power of substitution could also be built into the trust to allow the client to bring the copyright back into his or her estate prior to death, while preserving the exclusion of such copyright’s appreciation from his or her taxable estate.

Some commentators worry that the potential termination rights of the owner’s heirs triggered by a sale to a trust would constitute an IRC § 2036 transfer in addition to the actual sale of the copyright.\textsuperscript{84} As the purchase price paid by the trust would not constitute full and adequate consideration for the heir’s potential termination rights, a planner may consider whether the heirs should be required to provide consideration for such rights to avoid potential inclusion concerns.

c. Alternatively, the client could sell the copyright to a non-grantor trust when the copyright’s value is low to exclude the copyright from the reach of Section 1221(a)(3) and, thus, allow for capital asset treatment in the event of a future sale. However, this treatment is completely dependent on the transfer being classified as a sale only, with no portion of the transferee’s basis being based on that of the transferor.

d. Unfortunately, a gift of a copyright is unlikely to exclude the appreciation in such asset from the client’s taxable estate due to potential inclusion issues under IRC §§ 2036 and 2037.

IRC § 2036 includes the value of all property of which the decedent has made a transfer but retained for a period not ascertainable without reference to his or her death, or a period that does not in fact end prior to his or her death, the possession, enjoyment or right to income from the transferred property. If the owner dies before his or her right to terminate the transfer ripens, the client may be deemed to have retained for a period that did not end before his or her death the right to repossess the copyright, resulting in inclusion of the copyright in the owner’s taxable estate.\textsuperscript{85}

\textsuperscript{84} See Crawford, \textit{supra} note 13.
\textsuperscript{85} Note that the Code does not address whether rights that arise solely by operation of law and that are not waivable constitute “retained rights” for purposes of IRC § 2036. In \textit{Wyly v. Commissioner}, 610 F.2d 1282 (5th Cir. 1980), the Fifth Circuit held that rights granted to a decedent as a result of a state’s community property laws were not retained rights for purposes of IRC § 2036. Conversely, in Rev. Rul. 2004-64, 2004-2 C.B. 7, the IRS held that a trust’s required reimbursement of such trust’s grantor for any income tax attributed to such grantor constituted
IRC § 2037 includes the value of all property of which the decedent has made a transfer such that a recipient’s right to possession of enjoyment of the property is contingent upon surviving the decedent and the decedent retains a reversionary interest in the property. Again, if the owner dies before his right to terminate ripens, the owner may be deemed to have retained a right to repossess the copyright and the owner’s heirs may be deemed to hold rights to possess the copyright contingent upon surviving the owner. Thus, the copyright could be subject to inclusion under IRC § 2037 as well.86

3. Trademark: As compared to planning for a patent or copyright, transfer tax planning for a trademark held outside of (and not used by) a trade or business is rather simple. A trademark can retain capital asset treatment for purposes of a sale to an irrevocable trust over which the transferor retains no control, regardless of whether the trust is a grantor or non-grantor trust. Transfer to a GRAT, however, could prove problematic due to the transferor’s continued control over the asset.

B. Entity Interests

1. To exclude the appreciation in an entity interest and its income from a transferor’s taxable estate, a planner may consider all of the “usual suspects”, including a sale to an intentionally-defective grantor trust and a gift to a GRAT. Trusts that generate payment to the grantor, such as a GRAT, or allow the grantor indirect access, such as a trust benefiting the grantor’s spouse, may be ideal planning vehicles for an entrepreneur concerned with liquidity.

2. One additional consideration, however, is the retention of IRC § 1202 status. If the interest at hand qualifies as QSBS stock, a planner should be careful to transfer the interest to trust by gift, rather than sale, and may want to consider structuring the trust as a non-grantor trust in order to duplicate the owner’s QSBS exemption.87

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86 Treas. Reg. § 20.2037-1(c)(2) makes it clear that a reversionary interest created by operation of law is sufficient to trigger inclusion under IRC § 2037.
87 See Lee, supra note 54.
VI. CHARITABLE TRANSFER TAX STRATEGIES

A. IP:

1. A client looking for a tax-efficient way to convert an article of IP with significant built-in gain into liquid funds for transfer to both a non-charitable beneficiary and charity may wish to fund a charitable remainder trust (a “CRT”) with the IP asset. Under a CRT, a specified amount of the trust’s net fair market value (not less than 5% and not more than 50%) is paid to one or more non-charitable beneficiaries (which can include the trust’s grantor if transfer tax savings are not desired) on an annual or more frequent basis and the remainder passes to a charitable donee at the end of the trust’s term. The trust can last for either the lifetime of one or more individuals or for a period of years (not to exceed 20 years). The payments may take the form of an annuity (i.e., a set dollar amount) (a “CRAT”), a unitrust (i.e., a set percentage of the trust’s assets as valued at the beginning of each year) (a “CRUT”)[88], or the lesser of a unitrust amount or the trust’s annual net income (a “NICRUT”) with an optional makeup provision for years in which the trust’s net income exceeds the unitrust amount (a “NIMCRUT”). The NIMCRUT is especially well-suited for an asset that is not currently generating income but is expected to do so in the future. The NIMCRUT may also be structured so that it converts to a fixed CRUT upon the occurrence of an event outside the grantor’s control, such as the sale of an unmarketable asset.

A charitable remainder trust is a tax-exempt entity and, as a result, appreciated assets may be sold by the trust without the trust paying tax on the recognized gain. However, the trust’s non-charitable beneficiaries are responsible for income tax on income received from the trust. The donor receives a charitable income tax deduction at the funding of the trust on the then-present value of the property passing to charity at the end of the trust’s term. Additionally, property passing to charity at the end of the trust term also generates a charitable gift or estate tax deduction.

A CRT established at the donor’s death will provide the donor’s estate with a charitable estate tax deduction for the value of the remainder interest passing to charity but no income tax deduction. Additionally, as the asset used to fund the trust will receive a step-up in basis at the donor’s death, a CRT created during life is a far superior planning vehicle for income tax planning purposes.

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[88] Note that use of a unitrust will require an annual appraisal of the contributed asset.
It is worth noting that, depending on the IP asset at issue, it may be difficult to find a charity that is willing to accept such donation. The charity must have sufficient means and know-how to either license or sell the IP asset. If the charity is successful in securing a license of the asset, receipt of royalty income, less all directly connected deductions, is exempt from treatment as UBTI, except to the extent that the asset is debt-financed.\(^9\)

2. A charitable lead trust (a “CLT”), described below, is not a tax-exempt entity and, thus, it will not shield the trust’s beneficiaries from paying tax on capital gains on the sale of an appreciated asset. Additionally, the gift of an IP asset to a CLT would necessarily prevent capital asset treatment under IRC §§ 1221 and 1235. For this reason, generally, a donor would be better off selling the IP asset directly and funding a CLT with the proceeds.

A testamentary CLT could generate a charitable estate tax deduction to counter the value of an IP asset included in a donor’s estate. However, as an IP asset has a limited lifespan, the CLT may not be the most tax-efficient transfer vehicle to suit the donor’s needs.

B. Entity Interests:

1. Clients seeking to transfer a partial interest in an operating business to charity may wish to consider funding a CLT with such interest. Under a CLT, payments structured as either an annuity (a “CLAT”) or a unitrust (a “CLUT”) are paid to a charitable donee on an annual basis, with the remainder passing to one or more non-charitable beneficiaries at the end of the trust’s term. The trust can last for either the life of one or more individuals and/or a term of years with no maximum term.

If the trust is structured as a grantor trust, the donor will be responsible for income tax owed on the trust’s net income but will receive an income tax deduction for the present value of all future income distributions to the charity at the trust’s funding. Thus, a client can effectively “bunch” several years’ worth of income tax deductions into one year. This can be used to offset gain in a year in which the client experiences a liquidity event.

If the trust is structured as a non-grantor trust, the trust, not the grantor, will receive a charitable income tax deduction at funding. Similarly, the trust, not the grantor, will be responsible for paying income tax on the trust’s net income.

\(^9\) IRC § 512(b)(2).
The biggest benefit generated by a CLT is the charitable gift or estate tax deduction the donor recognizes at the trust’s funding. By picking the right term and annual payment structure, it is possible to produce a charitable deduction that equals the amount transferred to the trust’s non-charitable beneficiaries, thus creating a gift and estate tax-free transfer. Additionally, if the trust is structured as a CLUT (but not a CLAT), the trust can be structured to produce a charitable deduction that reduces the value of the amount transferred to the trust’s non-charitable beneficiaries to match the donor’s remaining GST tax exemption, thereby creating a GST tax-free transfer.

As mentioned above, a CLT is a taxable entity, meaning that the grantor or the trust must pay tax on capital gains recognized on the sale of an appreciated asset. For this reason, a client may wish to create a testamentary CLT that can generate a transfer tax charitable deduction with the benefit of an asset that has a stepped-up basis.

While IRC § 681 generally disallows a charitable income tax deduction to the extent a payment to charity consists of UBTI, the payment will be deductible up to the individual deductibility ceilings under IRC § 512(b)(11) if the payee charity is a domestic charity. Such deductibility ceilings are applied to the UBTI, not the trust’s entire income.

2. Operating business interests are typically poor candidates to fund a CRT. IRC § 664(c)(2) imposes a 100% excise tax on any UBTI produced by the trust’s assets. As a result, no one but the federal government benefits from any income produced by the entity interest while held in the CRT, an undesirable result for most clients.

VII. ADDITIONAL CONSIDERATIONS

A. Protection Costs. When considering the transfer of an IP asset to another individual or a trust, a planner should be sure to consider whether the recipient has sufficient funds to maintain the asset. For example, the owner of a trademark must be sure to file for additional 10-year renewal periods to maintain protection of such asset under the Lanham Act. Additionally, the recipient may need to be prepared to expend time and resources, including legal fees, to protect against infringement.

B. Effect on Potential Sale. A planner should also consider how such transfer might affect the client’s chances of selling the IP asset or business. An otherwise interested buyer might hesitate upon learning of a unique ownership structure, such as one that involves a charity or multiple trusts with differing trustees as owners. It may be possible to alleviate some potential buyer’s concerns related
to the sale of a business upfront by including provisions in the business’s organizational documents that ensure that minority owners must sell when the majority decides to sell (e.g., a “drag-along” provision).