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Beneficial Owner Information Reports Under the Corporate Transparency Act

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A number of estate planning and probate attorneys will indirectly do some work for their clients' business entities. For instance, an attorney may help an estate planning client retitle the client's corporate stock in the name of the client's newly created revocable living trust. Alternatively, an attorney may prepare an assignment, and/or restate or amend an operating agreement, to make clear that a deceased owner's former membership interest in a limited liability company is being conveyed from the probate estate to the decedent's heirs. For some of those clients, they may have no "business attorney" per se, and their only attorney may be the estate planning or probate attorney. If that is the case for some of your clients, you may be the only source to advise those clients with business entities of their new obligation to file a beneficial owner information report (a "BOIR") with the Financial Crimes Enforcement Network of the Department of the Treasury ("FinCEN") following the passage of the Corporate Transparency Act ("CTA"). And, even if you do not have clients needing that advice, you may personally have some BOIR reporting obligations based on ownership or substantial control of either the business entity through which you practice law, or some other business entity in which you are involved.

The CTA was passed on January 1, 2021, as Title LXIV in the package of laws comprising the National Defense Authorization Act of 2021. The CTA is intended to prevent money laundering. The CTA implements that goal by requiring each "reporting company" to file a BOIR with FinCEN detailing specific – and previously unreported - information about the reporting companies' "beneficial owners" and "applicants," as the CTA defines those quoted terms.

Reporting Companies

A "reporting company" under the CTA is essentially all corporations, limited liability companies, or similar entities that were created (or, in the case of entities created in other countries, registered to do business in the United States) by filing a document with the Oregon Secretary of State or any similar office under other state or tribal law. See 31 U.S.C. § 5336(a)(11)(A), as added by CTA § 6403(a). So, for example, most ordinary Oregon partnerships created by operation of law when two or more persons enter into a business enterprise for profit together are likely not "reporting companies" under the CTA, but most other domestic entities, which rely on a filing with the Oregon Secretary of State's office for their creation, will be reporting companies under the CTA. However, a number of specific types of entities, most of which are already

In This Issue

1 Beneficial Owner Information Reports Under the Corporate Transparency Act
5 Planning for the Oregon-Taxable Estate
9 Navigating the Value of Intangible Assets (Part 1)

highly regulated, are specifically exempted from the definition.[1] *See* 31 U.S.C. § 5336(a)(11)(B).

Beneficial Owners

A "beneficial owner" under the CTA is any individual who either exercises "substantial control" over a reporting company, or who owns or controls at least 25% of the capital or profits ownership interest of a reporting company. *See* 31 U.S.C. § 5336(a)(3)(A), as added by CTA § 6403(a); 31 C.F.R. § 1010.380(d). Persons deemed to have substantial control include one who:

(a) serves as a senior officer of the company (e.g., President, CEO, CFO, general counsel, COO, or other officer however nominated who performs a similar function for the reporting company, 31 C.F.R. § 1010.380(f)(8));

(b) has authority to appoint a senior officer or a majority of the board of directors (or similar governing body) for the reporting company; 31 C.F.R. § 1010.380(d)(1)(i)(B);

(c) directs, determines, or has substantial influence over important decisions made by the reporting company, including those relating to the nature, scope and attributes of the business of the reporting company, reorganization, dissolution or merger of the reporting company, major expenditures or investments, issuance of equity, incurrence of significant debt, or approval of the operating budget, selection or termination of business lines or ventures, or geographic focus, of the reporting company, compensation schemes and incentive programs for senior officers, entry into, termination, fulfillment or non-fulfillment of important contracts, amendment of substantial governance documents of the reporting company, 31 C.F.R. § 1010.380(d)(1)(i)(C); or

(d) has the circularly defined "any other form of substantial control over the reporting company," 31 C.F.R. § 1010.380(d)(1)(i)(D).

The ownership interests considered in determining whether the 25% ownership threshold is met are very broadly defined. An ownership interest includes any equity, stock or similar instrument, any capital or profits interests, an instrument which may be converted into equity, stock or similar instruments or a capital or profits interest in an entity, a future on such instruments, or a warrant or right to purchase, sell or subscribe to any equity, stock or similar instrument. *See* 31 C.F.R. § 1010.380(d)(2)(i). It also includes any put, call, straddle or other option or privilege to purchase any of the foregoing (except to the extent the option or privilege is created and held by third parties without the knowledge or involvement of the reporting company), and any other instrument, contract, understanding, relationship or mechanism used to establish ownership. *Id*. Both direct and indirect ownership interests of the owner are to be counted, including joint ownership, holding as a nominee, intermediary, custodian or agent for the owner, and through ownership or control of one or more intermediary entities, or the ownership interest of such intermediate entities. 31 C.F.R. § 1010.380(d)(2)(ii).

Importantly for estate planners, ownership or control of ownership interest is defined to include, with regard to a trust or similar arrangement that holds ownership interests, both the trustee who has authority to dispose of trust assets, the beneficiary who is the sole permissible recipient of income and principal or has the right to demand distribution of substantially all trust assets, or who is the grantor or settlor of a revocable trust or otherwise has rights to withdraw the assets from the trust. *Id*. When calculating the total ownership interests of a reporting company, ownership interests are to be calculated as of the present time, and any options or similar interests are required to be treated as having been exercised. 31 C.F.R. § 1010.380(d)(2)(iii). For reporting companies which issue capital or profits interests, the individual's ownership interests is the total of such interests calculated as a percentage of the total outstanding capital and profits interests. *Id*. For corporations and other reporting companies that issue shares of stock, the percentage of ownership is the greater of either the combined total voting power, or combined total ownership interest, held by the

1 Some of the more common entities exempted include: banks, federal and state credit unions, and bank holding and savings and loan holding companies; most securities brokers, dealers, exchanges, clearing agencies and other entities that are registered with the Securities and Exchange Commission; insurance companies regulated by insurance commissioners and which write policies of insurance or reinsure risks underwritten by insurance companies; insurance producers authorized by the State of Oregon or another state, subject to supervision by the insurance commissioner, and which have an operating presence at a physical office in the United States; public accounting firms registered with the Public Company Accounting Oversight Board; most entities described in one of the subsections of Section 501(c) of the Internal Revenue Code ("IRC") and which are exempt from tax under IRC Section 501(a); political organizations defined in IRC Section 527(e)(1) and exempt from tax under IRC Section 527(a); certain charitable or split-interest trusts under IRC Section 4947(a)(1) or (2); certain subsidiaries of an entity otherwise exempted under the CTA; and certain large business entities employing more than 20 full-time employees in the United States, with an operating presence at a physical office in the United States, and whose federal tax returns for the prior year demonstrate more than $5 million in gross receipts or sales. *See also* 31 C.F.R. § 1010.380(c)(1) and (2) (respectively giving the definition of a "reporting company", and exempting certain types of entities from that definition).

individual. Id. So, for example, a person who directly owns a 10% ownership interest in a reporting company A, and is trustee of a trust owning 50% of a different company B which in turn owns 25% of the outstanding stock of reporting company A, that person will be deemed to own only 22.5% (10% + (50% X 25%)) of reporting company A, but 50% of reporting company B.

However, the CTA exempts five different classes of persons otherwise meeting the definition of beneficial owner, including: (1) a minor child, if the information of the parent or legal guardian of the minor is reported; (2) individuals acting as nominee or other agent on behalf of another individual; (3) employees of a reporting company whose control is derived solely from employment (e.g., not ownership) status of the employee, and who are not a "senior officer" as described above; (4) persons whose only interest in the company is a future interest through a right of inheritance; and (5) certain creditors who would solely qualify as beneficial owner through rights or interests associated with the repayment of predetermined sums of money. *See* 31 U.S.C. § 5336(a)(3)(B), as added by CTA § 6403(a); 31 C.F.R. § 1010.380(d)(3).

Applicants

An "applicant" under the CTA is, for domestic U.S. entities created, or foreign entities registering to do business in the United States, any person who directly registers or files the application to create or register such entity. 31 C.F.R. § 1010.380(e)(1), (2). If more than one person is involved in the registration or filing, then the "applicant" also includes the individual who is primarily responsible for directing or controlling that filing. 31 C.F.R. § 1010.380(e)(3). However, reporting companies created or registered before January 1, 2024 are exempted from reporting information about their applicants, and need only report that they were so created or registered before that date. 31 C.F.R. § 1010.380(b)(2(iv).

BOIR Reporting Timelines

The timeline for submission of reports under the new regime of the CTA will vary depending on a variety of factors including whether it is the initial report, or an update or correction to an earlier report which is being filed, the date the entity was first created or registered (for initial reports), and the circumstances resulting in a change to an earlier report (for updated or corrected reports). The timeline for reporting is as shown in the table to the right

Circumstances	Report Due Not Later Than
Initial report for a reporting company in existence on or before December 31, 2023. 31 C.F.R. § 1010.380(a)(1)(iii)	January 1, 2025
Initial report for a reporting company created or registered during 2024. 31 C.F.R. § 1010.380(a)(1)(i)(A), (ii)(A)	Within 90 days of the date of filing which caused its creation or registration
Initial report for a reporting company created or registered in or after 2025. 31 C.F.R. § 1010.380(a)(1)(i)(B), (ii)(B)	Within 30 days of the date of filing which caused its creation or registration
Initial report for a reporting company which was previously exempt from reporting, but has lost the basis for such exemption. 31 C.F.R. § 1010.380(a)(1)(iv)	Within 30 days of the effective date of loss of exemption
Deadline to update a filed report which contains information which was once accurate but has since become inaccurate, generally. 31 C.F.R. § 1010.380(a)(2)(i)	Within 30 days of the change
Deadline to update a filed report for an entity which was previously not exempt, but since has become exempt. 31 C.F.R. § 1010.380(a)(2)(ii)	Within 30 days from the date the entity meets the criteria to become exempt.
Deadline to update a filed report for a transfer resulting from the death of a previously reported beneficial owner. 31 C.F.R. § 1010.380(a)(2)(iii)	Within 30 days from the date "the estate of the deceased beneficial owner is settled"[2]

2 The full text of the regulation on this point is as follows:

"If an individual is a beneficial owner of a reporting company by virtue of property interests or other rights subject to transfer upon death, and such individual dies, a change with respect to required information will be deemed to occur when the estate of the deceased beneficial owner is settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition. The updated report shall, to the extent appropriate, identify any new beneficial owners."

It is unclear to the author when, precisely, a person's estate will be deemed to be settled within the meaning of the federal rule in the cases of a simple estate, a probate, and a trust administration. For instance, one could argue that a simple estate becomes "settled" upon the filing of the simple estate affidavit. Alternatively, in the case of a judicially supervised probate or trust administration, or a non-judicial trust administration, different dates can be advanced depending on the circumstances. For instance, is the estate "settled" within the meaning of the regulation when there is an order or judg-

Contents of Initial BOIR Report

The BOIR report must be submitted online through the link at FinCEN's website at https://www.fincen.gov/boi. The initial BOIR report must include:

- The reporting company's
  - Full legal name.
  - Entity identification number.
  - Any assumed business names or trade names.
  - Street address for principal U.S. place of business.
  - State or tribe in which formed or, for non-U.S. foreign reporting companies, the state or tribe in which the foreign entity first registered.
- Each beneficial owner's
  - Full legal name.
  - Date of birth.
  - Residential street (not mailing) address.
  - Unique identifying number from a non-expired U.S. passport, or nonexpired state driver's license or other identification document issued by a state, local government or tribe. For persons who have none of those things, those persons may instead list the unique identifying number from a nonexpired passport issued by a foreign government.
  - An image of the passport, driver's license or other identification document from which the unique identifying number was taken, and containing both a photograph of the person and the identifying number used.
- For entities created on or after January 1, 2024, each applicant's
  - Full legal name.
  - Date of birth.
  - Residential street (not mailing) address, except that, in the case of a company applicant who files a formation document in the course of such individual's business, the business street address.
  - Unique identifying number from a non-expired US passport, or nonexpired state driver's license or other identification document issued by a state, local government or tribe. For persons who have none of those things, those persons may instead list the unique identifying number from a nonexpired passport issued by a foreign government.
  - An image of the passport, driver's license or other identification document from which the unique identifying number was taken, and containing both a photograph of the person and the identifying number used.

See 31 C.F.R. 1010.380(b)(1).

Penalties for Noncompliance

Companies should not ignore their reporting obligations. Willfully failing to file a report when due, or willfully filing a report containing incomplete or inaccurate information, can result in civil penalties of $500 per day that the violation continues, plus a criminal penalty of imprisonment for up to 2 years plus a $10,000 fine. 31 U.S.C. § 5336(h)(3)(A).

The information reported is technically confidential, and generally may not be disclosed except from federal agencies engaged in national security, intelligence, or law enforcement activities in connection with such activities, or from state, local or tribal law enforcement agencies for which the court has authorized it in a criminal or civil investigation, or foreign governments under similar circumstances. 31 U.S.C. § 5336(c)(2). Willfully making unauthorized use or disclosure of a report or disclosure under the CTA can subject a person to civil penalties of $500 per day, criminal penalties of imprisonment for up to five years plus a fine of $250,000 (or, if committed while violating another federal law or as part of a pattern of illegal activity, ten years imprisonment and a fine of up to $500,000). 31 U.S.C. § 5336(h)(3)(B).

Concluding Observations

Notwithstanding those protections, many commentators have expressed concerns about the depth and extent of the information required, and the potential for it to be subject to data breach or other misuse, and have requested the CTA be repealed or significantly amended. However, in light of the fact that the CTA passed with at least a 2/3 majority in a closely divided Congress, it seems probable that the reporting requirements of the CTA are here to stay in some form, absent judicial action.

At least one challenge has been successfully filed against the CTA as being in excess of the constitutional limits on Congress's power. *See* Memorandum Opinion filed March 1, 2024 as ECF# 51 in the case of *National Small Business United v. Yellen*, No. 5:22-cv-01448 (N.D. Ala.). However, FinCEN takes the position that the injunction as worded merely prevents FinCEN from enforcing the CTA against the plaintiffs to that suit: Isaac Winkles, reporting companies for which he is the beneficial owner or applicant, the National Small Business Association, and members of the National

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ment authorizing distribution of (or, in the case of a trust administration, the trustee elects to distribute) the decedent's ownership interest in a reporting company, but additional unrelated tasks remain outstanding in the probate or trust administration? In light of the penalties for noncompliance noted below, and in the absence of further guidance, it seems safest to report at the first available opportunity.

Small Business Association as of March 1, 2024. The government has appealed the order in that case.

Due to the fact entities in existence before January 1, 2024 have a year from that date to file their initial BOIR report, but generally only 30 days to file an update or correction to the earlier report, it seems prudent for existing reporting companies to wait until late in 2024 to file their initial report. Reporting companies newly formed in 2024 do not have quite as long for their initial report, but the same reasoning suggests they wait until later in their 90-day deadline to submit their initial report. Entities newly created is 2025 and thereafter have such a short window (30 days) to file their initial report, there is less reason to delay such filing.

Planning for the Oregon-Taxable Estate

By John H. Draneas, Draneas Huglin Dooley LLC

The federal estate tax provides for an indexed exemption that is currently $13,610,000, which is portable between spouses. Current law reduces the exemption to about $7,000,000 in 2026, but it remains indexed and portable between spouses. Due to portability, couples can safely leave all of their assets outright to each other without increasing their eventual federal estate tax burden.

With the large federal exemption, the clear majority of Oregon estates are exempt from federal estate tax. However, the Oregon estate tax situation is dramatically different. The Oregon exemption is $1,000,000, it is not indexed, and it is not portable. Once the estate exceeds the exemption, the tax rates can go as high as 16%.

Consequently, many of our clients have estates that are exempt from federal estate tax but subject to Oregon estate tax. The knee-jerk reaction is to plan the estate to minimize the Oregon estate tax by funding a $1 million bypass trust at the first spouse's death. That does not create an Oregon estate tax, and the bypass trust is excluded from the surviving spouse's estate. Adding in the surviving spouse's $1 million exemption, $2 million is thus exempted from Oregon estate tax.

As good as this strategy may appear, there are significant drawbacks:

1. The bypass trust assets lose the basis step-up at the surviving spouse's death, often causing the family more in income taxes than the Oregon estate tax savings.
2. Careful drafting is required to advantageously create the bypass trust.
3. Funding the bypass trust can be very challenging based upon the limited assets and their characteristics.
4. The bypass trust may become a detriment if circumstances change, such as the law changes or the surviving spouse moves to another state.

Part 1 - Income tax drawbacks

The most negative effect of the bypass trust is that, by exempting it from the surviving spouse's Oregon estate, you also exempt it from their federal estate. By doing so, you lose the §1014 basis step-up at the surviving spouse's death, which causes increased income taxes when the family disposes of the bypass trust assets. The increased income tax will often exceed the Oregon estate tax savings, making this a questionable strategy.

Calculating the differential is relatively easy at the maximum rates. Since we are dealing with appreciating assets, any gain recognized will likely be taxable as a long-term capital gain, with a corresponding maximum federal rate of 20%. Add in the 3.8% net investment income tax, and the 9% Oregon estate tax, and the total is 32.8% at the maximum. Compared to the maximum Oregon estate tax rate of 16%, the income tax burden is about double the estate tax savings.

The calculation is more fact-specific when the maximum tax rates do not apply to the situation. For example, the capital gains rate is 15% until taxable income exceeds $583,750 on a joint return. Similarly, the marginal Oregon estate tax rate is a more modest 12% until the taxable estate exceeds $6,500,000. But still, you're looking at a 27.8% income tax rate, which is more than double the 12% estate tax savings.

Timing must, of course, be taken into consideration. The Oregon estate tax is payable one year after death. The income tax from the sale of the appreciated assets is payable only after they are sold. If the assets are held for many years, or better yet, held until the beneficiaries' deaths to obtain a new basis step-up, the extended deferral or elimination of the income tax can result in the estate tax savings being more beneficial. However, we have to consider that predicting clients' future behavior is tricky at best, and people who say they will never sell an asset often change their minds later.

Part 2 - Drafting approaches

Once you have concluded that it makes sense to fund a bypass trust at the first death, there are three general approaches to the document drafting: a fixed formula, a disclaimer trust, and a *Clayton* marital deduction. Each has its pros and cons, and there is no always-right answer.

Fixed Formula. The fixed formula approach funds the bypass trust with the maximum asset value that will

not create an Oregon estate tax. Generally, you can use any traditional marital deduction formula designed around federal estate tax, - either a lead marital gift with the residue to the bypass trust, or a lead bypass trust gift with the residue to the marital gift. You just modify it to limit it to Oregon estate tax.

However you choose to draft it, it is strongly recommended that you use a fractional share formula, and not use a pecuniary formula. If appreciated assets are used to fund a pecuniary formula, and they are valued at their date of distribution values, then the assets are deemed to have been sold when distributed and gain is recognized on the appreciation. Reg. § 1.661(a)-2(f). This can be most damaging when the pecuniary gift comprises the larger share of the estate. These adverse income tax consequences are avoided by sticking to fractional share formulas.

Whichever formula you use, the division is mandated at the time of death, so nothing further needs to be done to qualify for the marital deduction and to properly fund the bypass trust. It also creates the luxury of time. The actual funding can take place years later when everything has been fully discovered, and asset selection for in-kind funding can be made with better information available.

The negative is that the division is mandatory. It may be that the bypass trust is not needed – say, the surviving spouse intends to move to a no-tax state – but it cannot be eliminated.

Disclaimer Trust. The most common approach is to rely upon the surviving spouse to make a disclaimer that funds the bypass trust. The advantage is that it defers the decision until the death of the first spouse, when better information is available. If the bypass trust is disadvantageous, such as where the survivor will move to a no-tax state, the disclaimer is not made, and the entire estate passes to the survivor with no ongoing trust to maintain. The disclaimer can be made as to a share of the trust, or as to specific assets.

There are some clear disadvantages.

The disclaimer must be made within nine months of death, and there is no ability to extend that deadline. Since that is a short time, and there has not been enough time for the final asset values to be determined for estate tax purposes, the disclaimer should always take the form of a formula disclaimer. Basically, that mimics the fixed formula approach.

The disclaimer must be made by the surviving spouse. For a number of reasons, fear, grief and control impulses being the major ones, it can be difficult to convince the spouse to disclaim.

The disclaimer must be made before the surviving spouse has accepted the assets to be disclaimed. In an age where non-probate transfers are the norm, many surviving spouses do everything they can to transfer assets to themselves before seeking legal advice, and by then it may be too late to disclaim.

The disclaiming spouse cannot have any control over the ultimate disposition of the disclaimed assets. The remainder beneficiaries of the trust must be fixed, and the surviving spouse cannot have a power of appointment over the disclaimer trust.

***Clayton* Election.** The appropriate division can also be made with a partial QTIP election. The negative to a partial QTIP election is that a fixed percentage of the QTIP trust will always be included in the surviving spouse's estate.

Clayton (Clayton, Arthur M. Jr. Est v. Com., (1992, CA5) 70 AFTR 2d 92-6262 , 976 F2d 1486, 92-2 USTC ¶6012) sanctioned the division of the partial QTIP trust into two trusts, one holding the QTIP-elected assets, and the other holding the unelected assets. During the surviving spouse's lifetime, distributions can be made from the QTIP-elected trust first, allowing the unelected trust to grow in value and maximize the estate exclusion.

The main advantage to the *Clayton* approach is that the decision is deferred until the due date of the Oregon estate tax return, which can be 18 months after death with an extension, at which time more information is available to make a well-reasoned decision. It also avoids the need for the surviving spouse to make a disclaimer at an awkward time when reason may not prevail.

The disadvantages are that the marital gift must be held in a QTIP trust, and that someone other than the spouse must be the personal representative or trustee who makes the partial QTIP election; otherwise, the surviving spouse is deemed to have a power of appointment and none of the assets are excluded from their estate. However, this drawback can be mitigated by providing for a special trustee whose only function is to direct the QTIP election.

Part 3 - Funding Limitations

The low tax threshold in Oregon can make it difficult or even impossible to fully fund a bypass trust at the first spouse's death. In many client situations, there simply aren't enough suitable assets available to do the job properly, and compromises will have to be made.

Consider, for example, a fairly typical Oregon couple's estate:

Residence	$1,000,000
Cash and marketable securities	100,000
IRAs and qualified plans	1,500,000
Personal property	100,000

Total Assets	$2,700,000

If the entire estate passes to the surviving spouse at the first death, and the values stay the same until the surviving spouse's death, there will then be $173,500 of Oregon estate tax owed. If $1 million were to pass to a bypass trust at the first death, then the tax payable at the second death would be reduced to $70,500. The $103,000 tax savings is certainly enticing. However, there is simply no good way to actually fund a $1 million bypass trust in this situation.

If we consider each of the assets individually, we will see that each of them presents its own difficulties as a funding candidate.

Residence. Funding the bypass trust with the decedent spouse's 50% interest in the residence has several significant shortcomings.

1. The residence will likely be sold after the second spouse's death. The 50% interest held in the bypass trust will not receive a second basis step-up at the surviving spouse's death, triggering capital gain tax on all appreciation after the first death. The §121 gain exclusion will not apply because the residence is owned by a trust.
2. Consider that the surviving spouse might choose or need to sell the residence during life, such as to generate funds for moving into assisted living. The bypass trust's sale of its 50% interest will not qualify for the §121 gain exclusion because that is not available to a trust. Consequently, capital gain tax will have to be paid on 50% of the appreciation after the first death.
3. Even if the residence is retained until the surviving spouse's death, the basis step-up on the spouse's interest will be limited because, as a fractional interest in the property, the 50% interest must be valued on a discount basis.

Cash and marketable securities. These assets are usable for the bypass trust funding, but the decedent's 50% share is only $50,000 in value, which doesn't accomplish very much.

IRAs and qualified plans. These assets are poor choices for funding the bypass trust for three reasons:

1. They are IRD, and all withdrawals from the accounts are fully income taxable as they are withdrawn. At 37% federal and 9% state income tax rates, they represent only a net 54% benefit.
2. When IRA and qualified plan benefits are payable to a trust, the surviving spouse loses the ability to do a spousal rollover, which is usually the best tax planning option available. That could force the funds to be withdrawn from the accounts faster, accelerating the income taxes, and reducing the long-term benefits of the accounts.
3. The timing of the distributions from the accounts can be quite complex when they are payable to a trust. If the bypass trust is to be treated as a conduit trust, it would have to make substantial distributions to the spouse each year, enlarging the spouse's estate and reducing the benefits of the bypass trust.

Personal Property. These assets are capable of being directed into the bypass trust, but they are depreciating assets and therefore a poor choice. Also, they are impractical assets to hold in a trust for administrative reasons.

No suitable solution. From a practical standpoint, it is simply not possible to fund the bypass trust with $1 million in this situation. Using the IRAs and qualified plans for this purpose is very problematic, and would produce highly undesirable results in most cases. The only suitable assets for funding the bypass trust are the deceased spouse's interests in the residence, cash and marketable securities, and the personal property. Although that adds up to only $600,000, it is actually the best that can be done in the example.

Spousal Purchase as Compromise

Of course, the example was specifically designed this way to illustrate that point. However, most estates in this value range will include similar assets to some extent. It will often be difficult, or impossible, to fully fund the bypass trust. And even when you fund it to the maximum extent feasible, the assets used to fund it will still present ongoing problems.

Fortunately, there is a good workaround. The suggested strategy is to take a two-step approach. First, fund the bypass trust with the most suitable assets that are available. Second, have the surviving spouse immediately purchase the assets from the bypass trust for a long-term promissory note at an appropriate interest rate.

Immediately after the bypass trust is funded, the surviving spouse would purchase all of the problem assets from the bypass trust at their estate tax value, giving a long-term note for the purchase price. With the purchase price being estate tax value, there would not be any gain recognized to the trust, and the surviving spouse's cost basis would be exactly equal to the trust's date of death value basis.

But note here that the purchase must be made before the assets change in value – otherwise, the purchase price might have to be increased, and that would create taxable gain for the bypass trust. While the value of the residence, cash and personal property might maintain stable values for a while, the marketable securities can change value

dramatically in a short time. So the sooner the sale is made, the better.

The risk of value changes can be alleviated by accelerating the surviving spouse's purchase so that the assets are purchased as soon after the date of death as possible. There is really no reason to wait until the bypass trust has been funded. The sale can be made by the estate or administrative trust before the bypass is funded, and the bypass trust can be funded with all or part of the spouse's note at a later time.

Structuring the note. When designing the terms of the spouse's note, several things have to be kept in mind:

1. The note must provide for adequate interest under §7872, which generally requires that the rate be at least equal to the Applicable Federal Rate at the time of the transaction.
2. Loan payments made by the spouse to the bypass trust constitute negative cash flow. That can be alleviated by designing the bypass trust so that it is required to distribute all its income to the spouse each year. Thus, all interest paid by the spouse is returned to the spouse, reducing the negative cash flow. However, principal payments would stay within the bypass trust.
3. The interest paid by the spouse will be taxable income to the bypass trust, allocated back to the spouse on the K-1. The taxable income effect can be alleviated in two ways. One, keep the interest rate as low as possible. Two, secure the note with a recorded deed of trust on the residence, thereby making the interest deductible as home mortgage interest. Recognize that the spouse's ability to beneficially deduct the interest may reduce the effectiveness of this approach.

Taking all that into account, the best solution is often to design the note so that payments are interest-only, with a balloon payment of all principal at a future date that is likely to be beyond the spouse's life expectancy – for example, interest only paid monthly, with all principal payable 15 years after the purchase. In that manner, the cash payments go from the spouse to the bypass trust, and then back to the spouse, with no negative cash flow.

Results of note approach. Funding the bypass trust with undesirable assets and then selling them to the surviving spouse in exchange for a note produces the following results:

1. The note is treated as a liability of the surviving spouse and reduces the estate by its principal amount. That effectively utilizes the deceased spouse's exemption, at least to the extent that the bypass trust was actually funded.
2. The note held by the bypass trust, or its proceeds if it is paid, passes estate-tax-free to the bypass trust beneficiaries. If the beneficiaries of the bypass trust are also the beneficiaries of the surviving spouse's estate, there is no negative consequence. However, if the beneficiaries differ, this entire strategy needs to be questioned.
3. The value of the bypass trust remains fixed at the principal amount of the note. While one might intuitively think that growth in its value would be beneficial, that may not really be the case. Any growth in principal would likely create capital gains tax liability to the beneficiaries, which would most always be greater than the estate tax savings.
4. The purchased assets are included in the surviving spouse's estate, achieving a basis step-up at the second death. Since the assets are owned 100% by the spouse, there is no fractionalization that forces valuation discounts to be used. That is an advantage, because valuation discounts would most always create greater capital gains tax liability for the family than the resulting estate tax savings.
5. The surviving spouse would be free to sell the residence at any time and take advantage of the $250,000 gain exemption under §121. With 50% of the residence gaining a cost basis when it was purchased from the deceased spouse's trust, the resulting taxable gain is minimized.
6. Bypass trust administration expenses are minimized, as the only items to report on its income tax returns are the interest received and distributed.

Part 4 – Building in Flexibility

The planner should always consider the possibility that future circumstances might change, and the bypass trust can become disadvantageous. For example, the spouse might move to a no-tax state, or the spouse's assets may be spent down to the point where the bypass trust serves no tax-saving purpose. There are many scenarios where the estate exclusion ends up paling in comparison to the loss of the basis step-up at the surviving spouse's death. Every estate plan that involves a bypass trust, no matter how it might be created, should include a mechanism for its subsequent termination.

Perhaps the best way to accomplish this is to draft the bypass trust so that an independent trustee can be appointed in the future, with the independent trustee having unlimited discretion to distribute trust principal to the surviving spouse, even to the point of exhaustion of the trust, whenever the independent trustee believes it to be appropriate. With such a provision, the family can have an

independent trustee appointed to exercise that power and thereby distribute all the bypass trust assets to the surviving spouse outright whenever the bypass trust proves to be detrimental.

Such a distribution, however, could upset the estate plan by allowing the surviving spouse to select the ultimate estate beneficiaries. If that is a concern, another approach is to give an independent trustee or protector the power to grant the surviving spouse a power of appointment over the bypass trust that is designed so it is unlikely to be exercised, but still constitutes a general power of appointment for estate tax purposes. If that power is granted, it will force the bypass trust assets to be included in the surviving spouse's estate, achieving a basis step-up at the second death. If it is not granted, the bypass trust remains outside the surviving spouse's estate.

§2041(b)(1) defines a general power of appointment as "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." Note that the four objects are joined by "or." Thus, a power exercisable in favor of any of those four objects would be a general power of appointment.

Thus, the surviving spouse can be given the power to appoint the trust assets in favor of the creditors of their estate, but no one else. It makes no difference if there are any creditors or not, and it makes no difference if the power is exercised or not. The mere existence of that power is enough to force estate inclusion.

If one is concerned that the surviving spouse might manufacture a favored estate creditor to appoint in favor of, the power can be designed so that it is exercisable only with the consent of a third party. So long as the third party is not an adverse party (i.e., not another bypass trust beneficiary), the power will still be considered a general power. The carefully chosen third party can thereby protect the integrity of the estate plan.

Navigating the Value of Intangible Assets (Part 1)

Richard Reynolds, CVA, MAFF, Managing Director of Silverpine Group

Introduction

Practitioners performing estate planning must be equipped to address all components of value, whether the purpose be charitable gifting, transfers, or measuring the fair market value of an operating business. While estate planning has traditionally focused on tangible assets like real estate and personal property, it now increasingly includes intangible assets such as intellectual property, digital assets, and interests in privately held businesses. This shift necessitates that estate planners adopt techniques to effectively identify and characterize these intangible assets subject to transfer.

Intellectual property, including patents, copyrights, and trademarks, often represents a substantial source of revenue either as standalone assets or as constituents of a company's balance sheet. Thus, measuring the value of these assets requires meticulous valuation and planning to ensure continued benefit to heirs or optimization of taxes. Transferring the rights to a famous novel or licensing of a patent exists not only in the realm of familial planning, but also in the world of charitable contributions. Separately, the rise of digital assets, such as cryptocurrencies and non-fungible tokens (NFTs), which are more akin to a contract on an idea rather than tangible work, adds further complexity. Effective management of these assets demands comprehensive documentation, clear instructions for transfer, and an understanding of varying legal frameworks and terms of binding agreements that drive valuation.

As we navigate the value of intangible assets, we must first understand the characteristics of such assets and how they are categorized. Intangible property may be represented by tangible documentation, but it typically lacks physical form and thus requires imagination to appreciate all facets of value and utility. This necessitates recognizing the inherent potential for revenue generation or cost mitigation while understanding the legal rights surrounding the asset and its strategic importance to its owner or the company that holds it. The discussion in this article provides a framework to assist estate planning attorneys in identifying and characterizing intangible assets. In the next part of this two-part series, we will explore the processes in which value is determined for intangible assets and consider several unique topics when planning for trusts and estates.

Characterizing Intangible Assets

In its most fundamental form, an asset is defined as "something of value owned by an individual or organization." For intangible assets, this definition expands to consider an asset as a legal bundle of rights with a claim on specified or implied future economic benefits that can be transferred by its owner. Consequently, intangible assets do not possess intrinsic physical properties that confer value but rather derive their value from legal entitlements. More specifically, intangible assets can be characterized by looking at six factors:

1. **Identifiable and Reasonably Described:** Intangible assets must be distinguishable from other assets and have a clear and specific description. For example, a patent for a unique chemical process can be identified by its patent number and described by its

detailed chemical formula and method of application. This specificity helps in recognizing the asset and differentiating it from other intellectual properties.

2. **Subject to Legal Existence and Protection:** Intangible assets are often granted legal status and protection under intellectual property laws. For instance, a trademark like the Nike “Swoosh” logo is legally recognized and protected against unauthorized use, ensuring exclusive branding rights for the owner.

3. **Transferable and Subject to Private Ownership:** Intangible assets can be bought, sold, or licensed to others, giving the owner flexibility in managing their use. A music company selling the rights to a song to another entity or licensing it for commercial use is an example of transferability. These ownership rights allow the asset to be monetized or transferred as needed, providing enhanced utility for that asset.

4. **Tangible Evidence of Existence:** Though intangible assets are non-physical, they are often supported by physical or digital documentation. For example, software development companies maintain records of source code, user manuals, and licensing agreements. The aggregation of these materials establishes the existence and ownership of their software products. In combination, these documents and records provide verifiable proof of the asset’s existence and how it may be used or capitalized on by its owner.

5. **Creation Date is Identifiable:** Intangible assets have a clear inception date when they are developed or legally recognized. The copyright for a book is established when the book is published, providing an identifiable “birthday” for that asset. This timestamp is crucial for determining the asset’s lifespan, taxable basis, amortization, and legal protection duration.

6. **Can Be Destroyed or Terminated:** Intangible assets can lose their value or legal protection over time due to external influences or obsolescence. For instance, a patent expires after a set period, typically 20 years from the filing date, after which the invention enters the public domain. On the contrary, that patent may lose value if a novel technology renders that patented technology obsolete. This characteristic highlights the potential temporal nature of intangible assets and the importance of managing them effectively to maximize their value.

Although these six characteristics provide a reasonable framework for identifying intangible assets, practitioners must exercise caution not to conflate an intangible asset with an economic phenomenon. Often one can observe a causal relationship between intangible assets and enhanced economic performance or profit. However, economic phenomena are symptoms of the existence of an intangible asset, not the asset itself. For example, a firm’s internal software might track specific key performance indicators (KPIs) to inform management of effective marketing activities. This software, as an integral intangible asset, enhances operational efficiency and decision-making, providing a competitive edge. By leveraging insights gained from the software, the company can optimize marketing strategies, reduce costs, and improve customer satisfaction. Consequently, the software (the intangible asset) is the catalyst for generating improved profitability and efficiency (the economic phenomenon).

Evidence of Intangible Assets: Benefits Streams

The characteristics and economic phenomena of intangible assets provide the premise for existence but falls short of substantiating a measurable value. Standard valuation methods are based on the concept that any asset, including intangible assets, are resources from which future economic benefits are expected to be received by that asset’s owner. These benefits can be bifurcated into two categories: superior income generation and mitigation of expenses.

Superior Income

Superior income generation refers to the ability of intangible assets to enhance the revenues of an organization beyond what could be achieved without them. These assets, such as patents, trademarks, and proprietary technologies, often provide a competitive edge that allows companies to command higher prices, expand market share, or discover new opportunities. For instance, a patented technology can enable a company to produce a unique product that meets specific consumer needs more effectively than competitors, thereby generating higher sales and profit margins. The presence of a recognizable trademark can lead to continued customer loyalty, price inelasticity, and ultimately premium pricing. Essentially, the intrinsic value of intangible assets is reflected in their potential to drive revenue growth and profitability through distinct market advantages.

Mitigation of Expenses

Mitigation of expenses involves the ability of intangible assets to reduce operational costs or avoid certain expenditures, thereby improving the overall efficiency and profitability of an organization. For example, a well-established proprietary process can streamline production, resulting in lower manufacturing costs and reduced waste. Similarly, intangible assets like customer databases and software systems can optimize marketing spend while improving customer satisfaction. Another example is the strategic use of intellectual property to prevent competitors from entering the market, thereby avoiding the costs

associated with price wars and loss of market share. By leveraging intangible assets to minimize expenses, companies can significantly enhance their financial performance and maintain a sustainable competitive edge.

Strategies for Identifying Benefits Linked to Intangible Assets

Some intangible assets may be easily identified by the estate planning attorney or valuation expert. For instance, if a revenue stream is labeled as royalties in a company's accounting records, then a royalty agreement likely exists to document the intangible asset, even if that asset is not recorded on the company's balance sheet. On the other hand, discrete evidence may not be apparent in the case of some intangible assets. Consider a company's customer relationships and brand reputation. These intangible assets often contribute significantly to the company's overall value but are not explicitly documented. Unlike a royalty agreement or a patent, customer relationships are developed over time through consistent service and satisfaction. Similarly, brand reputation is cultivated through marketing efforts, product quality, and customer experiences. While there might not be a specific contract or document proving the existence of these intangible assets, their impact is evident through increased customer loyalty, higher sales, and the ability to command premium prices.

A common strategy employed by the valuation expert is to compare the company and other market participants by performing financial ratio analysis to identify divergences from industry averages. For example, maintaining strong customer relationships may be evidenced by higher-than-normal customer retention rates, superior gross profit margins, or lower marketing costs since servicing existing customers typically requires less marketing spend than acquiring new ones. Further, as a valuation expert gains comfort with specific industries, that professional develops insight into "usual suspects" of intangible assets that contribute to value. Consequently, they should be able to elicit responses from business owners about intangible assets that might otherwise be overlooked by less experienced professionals.

Overlooking intangible assets in estate planning and gifting can lead to materially significant tax consequences. While omission may present a smaller taxable estate, it can lead to disputes with tax authorities, resulting in penalties, interest, and legal fees if the omission is discovered. For gifting, undervaluation can affect the calculation of gift taxes, as the transferee might report a lower value than the actual fair market value of the gifted asset. This not only risks penalties and interest but can also complicate future transactions or valuations if the gift's true value is later scrutinized. Specifically, taxation implications include potential challenges from the IRS or other tax authorities, who may reassess the value of the estate or gift, leading to unexpected tax liabilities. Moreover, beneficiaries might face complications if the business needs to be sold or transferred, as the corrected valuation could impact capital gains taxes and create internal conflict. Accurate inclusion of intangible assets ensures compliance, avoids legal complications, and provides a clear financial picture for both estate planning and gifting purposes.

Defining the Value of Intangible Assets

Although intangible assets can be characterized and substantiated by several tests, a universal framework and set of standards for their measurement has not yet been codified or agreed upon by academic and governing bodies, leading to varying definitions. For financial accounting, taxation, or transaction purposes, the definition of intangible assets is typically derived from statutory authority or standards boards such as the International Accounting Standards Board (IASB) or the United States Generally Accepted Accounting Principles (U.S. GAAP). While the legal framework set forth by Internal Revenue Code (IRC) Sections 197 and 482 provide a definition and guidance to account for federal income tax amortization and transfer pricing, the U.S. accounting code under Accounting Standard Codification (ASC) 350 offers direction for appropriately accounting for intangible assets in financial reporting.

Even though prior characterizations of intangible assets may provide a paradigm for explaining their function and form, they do not necessarily offer insights into how or why these assets should be valued. Consider the valuation of a patented technology owned by a company. If the purpose of the valuation is for financial reporting under U.S. GAAP, a fair value definition may require measurement based on expected future cash flows from the technology, discounted to present value, and with respect to market participant assumptions and rates of return. This approach might account for specific synergies the acquirer expects to achieve, leading to a higher valuation. Conversely, if the valuation is for gifting purposes and requires a fair market value definition under the U.S. tax code, the appraisal might focus on the price a willing buyer would pay in the open market, potentially resulting in a lower value due to the lack of specific synergies a market participant might not realize. Thus, definitions of value specific to the purpose of the assignment directly influence the valuation of the same intangible asset.

Types of Intangible Assets

It would be nigh impossible to provide an exhaustive list of all types of intangible assets given the wide diversity of assets that support business activities throughout all industries. However, we can categorize intangible assets into six broad categories to assist in identifying these assets.

1. **Intellectual Property (IP):** These intangible assets may enjoy superior legal protections than other intangibles. IP laws are well-established and internationally recognized, providing a clear framework for the protection and enforcement of patents, trademarks, copyrights, and trade secrets. These laws grant specific exclusive rights to creators and inventors, allowing them to control and benefit from their creations.

2. **Franchises:** Agreements where a franchisor grants the franchisee the rights to operate a business using the franchisor's brand, business model, and support systems. Franchise agreements typically require franchise fees and ongoing royalties in exchange for providing access to a proven business model and market recognition.

3. **Licenses and Permits:** These are legal permissions granted by authorities to conduct specific activities or use certain technologies. They can include broadcast licenses, software licenses, and environmental permits, which are crucial for regulatory compliance and operational functionality.

4. **Customer Lists and Relationships:** Customer lists include data on past and current customers, such as contact information and purchase history. Customer relationships reflect the established rapport and loyalty built over time, leading to repeat business and referrals. Both are valuable for targeted marketing and sustaining revenue streams.

5. **Financial and Digital Assets:** Financial assets are considered intangible assets because they represent ownership or claims to future economic benefits without having a physical form. While some financial assets may have publicly available indications of value (e.g. stocks, corporate bonds), privately held equity and debt may have little support to substantiate value. Another emerging class of financial securities includes digital assets, including cryptocurrencies, digital art (such as NFTs), and social media accounts. Given their nascency and volatility, digital assets often necessitate consideration of asset-specific risks, liquidity, and regulations.

6. **Goodwill:** Goodwill encompasses the positive attributes that enable a business to earn higher profits than its competitors, often leading to increased customer loyalty, repeat business, and a strong market presence.

Demystifying Goodwill

A comprehensive understanding of goodwill and its interpretations may require knowledge in anthropology, law, and history, as the concept is as old as human commerce. One of the earliest legal interpretations of goodwill was articulated by Lord Eldon in the 1810 case of *Cruttwell v. Lye*, where he defined it as "nothing more than the probability that old customers will resort to the old place." Despite numerous attempts by legal scholars and business professionals to define goodwill since then, the term lacks a universal definition. However, valuation and legal experts generally recognize three types of goodwill.

Enterprise goodwill, also known as institutional goodwill, arises from the ongoing operations of a business. This form of goodwill is generated by the business as a whole rather than individual efforts, encompassing the business's reputation, brand strength, customer loyalty, and operational efficiencies. It is usually more transferable than other forms of goodwill due to its association with the overall operations, brand, and customer base of a business, making it an attractive asset during a sale.

Professional practice goodwill is associated with professional service firms such as medical, dental, legal, and accounting practices. It results from the personal relationships and reputations developed by the professionals within these companies. This type of goodwill is heavily influenced by the trust and rapport that professionals build with their clients, leading to long-term client retention and referrals. However, professional practice goodwill is less transferable due to its reliance on personal relationships, complicating its valuation and transfer.

Celebrity goodwill has recently garnered the attention of legal experts and the IRS. Derived from an individual's fame and influence, it relates to the value of a person's name, image, and likeness (NIL). This type of goodwill is particularly relevant for public figures such as actors or professional athletes, whose personal brand and public perception can generate substantial income through endorsements, appearances, and merchandising. Initially thought to apply only to famous actors or singers, celebrity goodwill now includes college athletes, social media influencers, and video game content creators. This expanding category of goodwill underscores the evolving nature of personal branding in the digital age and its significant economic implications.

Conclusion

As intangible assets increasingly become valuable components of estates, advisors must possess at least a foundational understanding of how to identify and characterize these assets. Overlooking such assets when performing estate planning may lead to costly penalties and a loss of credibility. Legal professionals and valuation experts should strive to enhance their knowledge before providing recommendations or opinions of value as the

ever-growing list of intangible assets demands continuous education. Intellectual property, backed by extensive legal frameworks, requires precise valuation and strategic transfer to preserve economic potential. In contrast, digital assets require meticulous documentation and a nimble understanding of regulatory landscapes and volatile microeconomies. Goodwill, particularly within professional and celebrity contexts, presents unique challenges in valuation and transfer due to its reliance on personal relationships and public perception.

Recognizing these complexities underscores the importance of a sophisticated conceptual framework and rigorous categorization of intangible assets to determine optimal estate planning strategies. The subsequent article in this two-part series will elaborate on methodologies for valuing intangible assets and address special considerations for trusts and estates.

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