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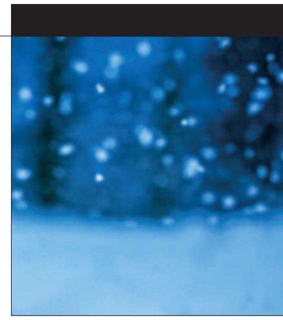

Securities Law Considerations for Estate Planners

Sale or transfer of securities can trigger unexpected obligations, which planners should consider when part of the client's asset mix.

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One of the primary goals of estate planning is to achieve tax-efficient outcomes for clients without hindering the clients' non-tax objectives, including their investment opportunities. This balancing act requires estate planners to have an understanding of the federal securities law and, in particular, the following four primary acts: (1) the Securities Act of 1933, (2) the Securities Exchange Act of 1934, (3) the Investment Advisers Act of 1940, and (4) the Investment Company Act of 1940.[1] Many estate planning vehicles and the high-net-worth individuals who use them are subject to regulatory requirements, compliance with which can be both expensive and time-consuming.

This article is intended to help estate planners by providing an overview of the applicable federal securities law considerations and then discussing the application of those laws to various estate planning transactions. The overview of applicable federal securities laws addresses each of the four primary acts and discusses some of the most relevant concepts in each. Then, the discussion of estate planning transactions identifies issues presented when clients make different types of transfers for estate planning purposes, which broadly include: outright lifetime transfers; lifetime transfers in trust; testamentary transfers; transfers of interests in entities and special assets; and transfers to charitable entities.

Federal Securities Law: Four Primary Acts

Following the stock market crash of 1929, Congress enacted the four primary acts of federal securities law and created the U.S. Securities and Exchange Commission (SEC) to administer them. Understanding the application of each of these four acts will help estate planners identify when clients may be subject to federal securities laws and understand how these laws, and the rules and regulations promulgated thereunder, may affect clients' estate planning goals and options.

Securities Act of 1933. The Securities Act of 1933 (Securities Act) regulates offers and sales of securities in the United States. The Securities Act has two primary objectives: (i) ensuring that investors receive adequate disclosure regarding a proposed investment, including business and financial information concerning the issuer of the securities and the terms of the offered securities and (ii) prohibiting misrepresentations and other fraud in the sale of securities in order to protect investors and ensure the integrity of the public markets. In general,

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pursuant to Section 5 of the Securities Act, securities sold in the United States in public offerings must be registered with the SEC unless there is an available exemption from the registration requirements.

In connection with an estate-related transfer, a transferor must consider whether the proposed transfer involves a "sale" of "securities," whether the sale would be viewed as a public offering subject to registration under the Securities Act and, if so, whether there is an available exemption from the Section 5 registration requirements.

Definition of "Security." Many financial instruments likely fall within the definition of a "security" under the Securities Act, which has been further interpreted by the Supreme Court. Under Section 2(a)(1) of the Securities Act, "security" is broadly defined 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.

The Court has further clarified that this definition is only intended to include "the many types of instruments that, in our commercial world, fall within the ordinary concept of a security."[2]

The Court has suggested that an "instrument commonly known as a security" and an "investment contract" have the same meaning for purposes of the Securities Act. In order to determine whether an instrument should be considered a security, the *Howey* case and subsequent case law have found that an "investment contract" exists when there is the investment of money in a common enterprise with a reasonable expectation of profits to be derived from the efforts of others.[3] The "*Howey* test" applies to any contract, scheme, or transaction, regardless of whether it has any of the characteristics of a typical security.

Rule 144. Once an instrument is determined to be a security, it is important to consider the status of the security and whether it is a "restricted security" or a "controlled security" that may be subject to restrictions on transfer. Understanding these terms requires estate planners to also understand various related terms defined in Section 144, such as whether a person may be deemed to constitute an "underwriter" or an "affiliate."

Rule 144 under the Securities Act defines a "restricted security" as a security that was acquired in unregistered, private sales from the issuer or from an affiliate of the issuer, including, but not limited to, securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering. "Control security" is also defined by Rule 144 as a security that is held by, or sold on behalf of, an affiliate of, or a control person of, the issuer, regardless of whether such security was acquired in a public offering, which may include registered securities acquired by an affiliated dealer of the issuer (typically in a market-making transaction).

Rule 144 is a non-exclusive safe harbor that sets forth certain conditions that must be satisfied by the seller of securities, other than the issuer of the securities, relating to the resale of "restricted securities" and "control securities." A holder of restricted or control securities may choose to satisfy the applicable conditions of Rule 144 in connection with resales of securities in order to ensure that, in connection with its resales, it is not deemed to be engaged in a "distribution" of securities and not considered to be an "underwriter" with respect to that securities transaction.

An "underwriter" is defined under Section 2(a)(11) of the Securities Act as any person who (i) buys from an issuer, or its affiliates, with a view to distribution; (ii) offers or sells for an issuer, or its affiliates, in connection with the distribution of a security; (iii) participates, or has a direct or indirect participation, in such distribution; or (iv) participates or has a participation in the direct or indirect underwriting of such distribution. Individual

1 The federal securities laws are primarily codified in Title 15 of the U.S. Code.

2 *Marine Bank v. Weaver*, 455 U.S. 551 (1982).

3 *SEC v. W.J.Howey Co.*, 328 U.S. 293 (1946). Although the definition of a "security" in *Howey* differs from the Securities Act definition noted above, the Court has referred to the two definitions as being "virtually identical."

4 An exemption is also available based on the type of security being offered under section 3(a)(11) of the Securities Act, generally known as the "intrastate offering exemption," which facilitates the financing of local business operations. A "safe harbor" providing objective standards for the exemption can be found in Rule 147 and Rule 147A of the Securities Act.

5 Rule 504 exempts offerings of $10 million or less in any 12-month period, while Rule 506(c) allows issuers to broadly solicit and generally advertise the offering, so long as all of the investors are accredited investors and the issuer takes reasonable steps to verify their status as accredited investors.

investors also may be "underwriters" within the meaning of Section 2(a)(11) if they "act as links in a chain of transactions through which securities move from an issuer to the public." Compliance with Rule 144 therefore provides assurance that a seller of securities is not an "underwriter" and the sales would not be considered a "distribution" subject to registration.

In order to comply with Rule 144, an individual must comply with certain basic requirements, including requirements relating to current public information, a holding period, and, in the case of affiliate sales, certain volume limitations, manner of sale requirements, and the filing of a Form 144.

Ultimately, when clients seek to resell restricted or control securities, estate planners should carefully review the applicability of Rule 144 to determine if the basic conditions have been met and if the seller may rely on the exemption for that resale.

Other Exemptions under the Securities Act. Estate planners should also be aware of the other exemptions from the registration requirements that may be applicable to the securities that a client is considering selling. The registration and prospectus delivery requirements for securities offerings are set forth in Section 5 of the Securities Act. A number of exemptions from the Section 5 registration requirements are available, based on the type of transaction in which the security is being offered and sold.[4]

If the transaction involves a private offering or limited public offering, it may be exempt from registration under Section 4 of the Securities Act and the rules thereunder. Private placements, which are "transactions by an issuer not involving any public offering," are exempt from registration pursuant to various provisions of Section 4(a) of the Securities Act. Determining if a specific transaction is a "private placement" is a fact-specific analysis that involves consideration of various factors, including, among other things: the number of offerees and their relationship to each other and to the issuer; the number of securities offered; the size of the offering; the manner in which the offering is conducted (i.e., the absence of general advertising and general solicitation); the sophistication of the offerees; the nature and kind of information provided to offerees or to which offerees have ready access; and the actions taken by the issuer to prevent resale of the securities.

For purposes of Section 16 of the Exchange Act, when an insider-grantor exercises sole investment control over a revocable trust and has the power to revoke the trust without the consent of another person, the insider-grantor will be treated as the beneficial owner of the securities held in trust.

An issuer may rely on the Section 4(a)(2) exemption when it is selling securities to a limited number of institutional or highly sophisticated investors. This exemption is only available to issuers, rather than resellers, and requires the issuer to ascertain that a purchaser is a "sophisticated investor," among other requirements. Issuers may also rely on Regulation D, which includes the safe harbors under Rule 504, Rule 506(b) and Rule 506(c).[5] Rule 506(b) is the safe harbor most often relied upon for private placements and provides an exemption for limited offerings and sales without regard to the dollar amount. Although the number of "purchasers" under Rule 506(b) is limited to 35, issuers may sell securities under Rule 506 to an unlimited number of "accredited investors" (as defined below). Any purchaser of securities in an exempt transaction under Regulation D will hold restricted securities.

Non-issuers may rely on the case law-developed (and SEC-recognized) exemption for private resales of securities known as "Section 4(a)(1½)," or the statutory non-exclusive safe harbor of Section 4(a)(7) of the Securities Act. Section 4(a)(1½) exempts the private resale of securities by non-issuers even if such resale may not otherwise meet the conditions of Rule 144, provided that the sale meets the general conditions for private issuances under Section 4(a)(2). However, a transferee buying securities under the Section 4(a)(1½) exemption will receive restricted securities rather than freely transferable securities received in sales made in reliance on Rule 144. Section 4(a)(7) of the Securities Act, by contrast, is a non-exclusive safe harbor for resales that resembles, but does not replace, the Section 4(a)(1½) exemption, with various additional conditions, including information-reporting.

Limited public offerings may also be exempt from registration requirements under Regulation A (Reg. A) under Section 3 of the Securities Act, and securities sold in a Reg. A offering are not considered restricted securities.

Definition of "Accredited Investor." "Accredited investor" status plays an important role in determining the registration requirements or exempt status of a transaction and in determining whether an individual may invest in certain offerings. Broadly, an "accredited investor" is a person or an entity that is financially sophisticated and therefore can bear the risk of loss, fend for itself, and does not require the protections provided by the disclosures contained in a registration statement.

Rule 501 of Regulation D specifically defines an "accredited investor" in various categories. A natural person may be an accredited investor if he or she and his spouse have a net worth in excess of $1 million (excluding a primary residence). A natural person may also qualify if he or she had an individual income in excess of $200,000 in each of the two most recent years or joint income with a spouse or partner in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year. Trusts qualify as accredited investors if they are irrevocable, have assets of $5 million, were not formed specifically to acquire the offered securities, and if purchases are directed by a specific person. Revocable trusts may qualify if each grantor with the power to revoke would qualify. Institutional investors, such as banks or insurance companies, and employee benefit plans may also qualify. Other entities, such as tax-exempt organizations, corporations, LLCs, or partnerships qualify if (i) the entity has total assets in excess of $5 million and it was not formed for the specific purpose of acquiring the securities offered or (ii) all of the equity owners are themselves accredited investors. An issuer's directors, executives, and general partners also qualify as accredited investors with respect to sales of that issuer's securities.

The SEC recently amended the definition in order to add new categories, which include a natural person, regardless of income or net worth, if he or she has certain licenses and is in good standing[6] or if he or she is a "knowledgeable employee." Additional entities also qualify as accredited investors, including any family office with at least $5 million in assets under management.

Ultimately, estate planners should be familiar with these provisions of the Securities Act and the regulations thereunder as they advise clients about the consequences and estate planning viability of potential transactions.

Securities Exchange Act of 1934. The Securities Exchange Act of 1934 (Exchange Act)[7] created the SEC and empowered the SEC with broad oversight authority over all aspects of the securities industry. Understanding the broad impact of the Exchange Act is critical for estate planners as they help clients, especially "insider" clients, negotiate their estate planning transactions. In particular, the disclosure requirements, short-swing profits rules, trading limitations and holding periods imposed on insiders should be considered in even the most basic estate planning transactions.

Definition of "Insider." Identifying whether a person may be considered an "insider" is important for estate planners. An "insider" generally is thought to include a "company's officers, directors, or someone in control of at least 10% of a company's equity securities" (Insider and collectively, Insiders).

Reporting Requirements. Insiders generally are subject to the reporting requirements of Section 16 of the Exchange Act, including the requirements to file Form 3, Form 4, and Form 5 regarding such Insider's beneficial ownership of securities of a public company.[8] Form 3 is the "Initial Statement of Beneficial Ownership," which details each Insider's direct and indirect beneficial ownership of equity securities of the company; Form 3 must be filed on or before the effective date of a company's initial public offering or within 10 days of becoming an Insider. Form 4 is a "Statement of Changes in Beneficial Ownership," which must be filed within two days of a material change in the holdings of a company Insider, including grants, awards, dispositions of securities, and sales by the Insider. Form 5 is an "Annual Statement of Changes in Beneficial Ownership of Securities" and must be filed annually by an Insider if the Insider had any exempt transactions not previously listed on a Form 4 or if the Insider failed to file the required Form 3 or Form 4 for the applicable fiscal year. Many estate planning transactions entered into by an Insider may implicate these filings.

Section 16(b): Short-Swing Trading Provisions. Due to the potential liability, estate planners must be wary of potential "short-swing" transactions under Section 16(b) of the Exchange Act. According to Section 16(b), "any profit realized by an

6 As of the date of this article, this includes licensed securities representatives (Series 7), licensed investment adviser representatives (Series 65), and licensed private securities offerings representatives (Series 82).

7 The Exchange Act is codified as amended at 15 U.S.C. section 78a et seq.

8 Insiders and non-insiders who directly or indirectly acquire beneficial ownership of more than 5% of an issuer's outstanding securities may also be subject to reporting requirements under Sections 13(d) and 13(g) of the Exchange Act, which require that applicable parties file a Schedule 13D or a Schedule 13G within 10 days of a transaction affecting an investor's beneficial ownership in the company.

9 Such a Rule 10b5-1 plan provides the holder an affirmative defense to a charge of an illegal insider trade. The affirmative defense is only available, however, if the plan was entered into when the holder, officer, director, or insider did not actually have any MNPI and if the trades are in fact made pursuant to the preset terms of the plan.

10 The Advisers Act is codified as amended at 15 U.S.C. section 80b et seq.

Insider within any six-month period from matching purchases and sales, or matching sales and purchases, of company securities is recoverable by the company."

This is a strict liability standard, without exception for good faith mistakes or misunderstandings of law, even where no non-public information was misused. The highest sale price will be matched against the lowest purchase within that period to determine if the Insider received "short-swing profits," which can result in deemed profits, even if the Insider lost money on the transactions. Companies cannot waive the right to recover short-swing profits, and any stockholder can bring a derivative suit to recover such profits.

Insider Trading under Rule 10b-5, Trading Plans, and Blackout Policies. Estate planners must also consider the company insider-trading limitations in advising Insider clients. Insider trading refers generally to: buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, on the basis of material non-public information (MNPI) about the security. Insider trading violations may also include "tipping" such information, securities-trading by the person "tipped," and securities-trading by those who misappropriate such information.

Rule 10b-5 of the Exchange Act codifies this prohibition by making it unlawful for directors, officers, employees, or their "tippees," to trade for their benefit, or similarly recommend trading in securities, on the basis of MNPI. Ultimately, no director, officer, or employee of the company should trade when in possession of MNPI and no one with knowledge of material inside information may provide "tips" for trading by others.

While companies generally disclose material information on a timely basis, there are "blackout periods" when companies require information be kept in confidence. Blackout periods are not required to be established by the SEC or statute, but most public companies establish blackout periods to prevent unlawful trading by directors, executives, and employees. Generally, blackout periods relate to times when insiders might have access to sensitive information, like quarterly financial results. During these blackout periods, persons having MNPI *should not* trade in company securities for any reason.

In order to defend against the potential criminal and civil penalties imposed on a violation of the insider trading laws, large stockholders, officers, and directors of public companies may sell securities in accordance with the parameters of Rule 10b5-1 of the Exchange Act. Under Rule 10b5-1, large stockholders, directors, officers, and other insiders who regularly possess MNPI but who nonetheless wish to buy or sell stock may adopt a written trading plan that specifies the amount, price, and specific dates of purchases or sales.[9]

Investment Advisers Act of 1940. The Investment Advisers Act of 1940 (Advisers Act)[10] defines the roles and responsibilities of an investment adviser by providing the framework to monitor those who advise pension funds, individuals, and institutions on investing. The Advisers Act specifies what qualifies as "investment advice" and stipulates who must register with state and federal regulators. While beyond the scope of this article, the SEC's jurisdiction over advisers is not exclusive and each state also regulates advisers with offices or clients in that state.

An investment adviser (Adviser) is defined in Section 202(a)(11) of the Advisers Act as any person or firm that is, for compensation, engaged in the business of providing advice to others or issuing reports or analyses regarding securities. Advisers are generally required to register with the SEC and comply with applicable regulations under the Advisers Act, including limitations on Advisers charging fees "on the basis of a share of capital gains upon or capital appreciation of a client's account" unless the client is a "qualified client." A qualified client must have at least $1 million under the management of the Adviser; have a net worth of more than $2.1 million; be a "qualified purchaser" (as defined under the Investment Company Act of 1940); or be an executive officer, director, or another "knowledgeable employee" of the Adviser.

The most applicable exclusions for individuals or entities who may otherwise be Advisers are found in the "3(c)(1) exemption" and the "3(c)(7) exemption" of the Investment Company Act of 1940 (Investment Company Act),[11] each of which is discussed in greater detail below. In the case of a private investment fund that relies on Section 3(c)(1) of the Investment Company Act or a registered investment company, the Adviser must "look through" the fund and may only charge such fees with respect to investors who are qualified clients. Funds that rely on Section 3(c)(7) are not subject to the Advisers Act's restrictions on performance fees.

Investment Company Act of 1940. The Investment Company Act governs the registration and regulation of investment companies, which are entities that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public (e.g., mutual funds, closed-end funds, and unit investment trusts). Under the Investment Company Act, every investment company is subject to registration and regulation unless it is exempt.

Section 3(c) of the Investment Company Act excludes certain issuers from the definition of an investment company. These issuers include, for example, broker-dealers, charitable organizations, pension plans, and church plans. The two most frequently used exemptions under the Investment Company Act are often relied upon by hedge funds and private equity firms. These exemptions are available if (1) a fund does not make, or propose to make, a public offering of its securities and (2) either (a) limits the fund to no more than 100 investors (the 3(c)(1) exemption) or (b) limits the fund to "qualified purchasers" (as discussed below) (the 3(c)(7) exemption).

While the 100-owner rule under the 3(c)(1) exemption sounds simple, the counting rules can be complex depending on the circumstances (for example, an involuntary transfer by gift, bequest, or divorce will be treated as owned by the transferor). Funds should carefully review the applicable counting rules when relying on the 3(c)(1) exemption.

Frequently, estate planners will need to understand the rules defining qualified purchasers under the 3(c)(7) exemption to help determine if clients or their estate planning vehicles can invest in a fund. Generally, a qualified purchaser is an investor that meets any of the following:

- an individual or family-owned business not formed for the specific purpose of acquiring the interest in the fund that owns $5 million or more in investments;
- a trust not formed for the specific purpose of acquiring the interest in the fund, which is sponsored by and managed by qualified purchasers;
- an individual or entity not formed for the specific purpose of acquiring the interest in the fund which owns and invests at least $25 million in investments (or someone who is acting on account of such a person); or
- an entity, of which each beneficial owner is a qualified purchaser.

The terms "qualified purchaser" and "accredited investor" are often (incorrectly) thought to be synonymous. However, there are some key differences. Most notably, the financial thresholds for accredited investors are significantly lower than those for qualified purchasers. Qualified purchasers must have at least $5 million of investments. For this reason, qualified purchasers are sometimes referred to as "super-accredited" investors or some variant of that term.

A cautious estate planner might advise an insider-grantor to report his retained power to remove the trustee on a Form 4 to ensure that the insider-grantor complies with any possible reporting requirements.

Estate Planning Transactions

Estate planners rely on a variety of tools and transactions to achieve their clients' tax and non-tax objectives. An understanding of securities laws and how securities laws relate to these tools can help estate planners provide better advice to clients. This section illustrates how the securities laws described in the preceding section impact various estate planning transactions and refer to examples applicable to a typical high-net-worth individual.

Outright Lifetime Transfers. One of the most common tools for any estate planner is an outright transfer from a client to a family member, such as a client's child. A high-net-worth individual may wish to gift shares of publicly traded stock as part of a lifetime transfer in order to utilize his or her annual exclusion or lifetime exemption or otherwise to "freeze" the asset for estate tax purposes and transfer the stock's appreciation out of the donor's estate. When a client is an insider of a publicly traded company under Section 16 of the Exchange Act (i.e., a director, officer or 10% beneficial owner), an outright lifetime gift of shares in that company will have securities law implications for the client-donor, the child-donee, and the public company.

With respect to the client-donor, a gift of shares in the public company will be considered a disposition of beneficial ownership, which will require the client-donor to report the transaction on a Form 4 or a Form 5.[12] The insider-trading requirements of Rule 10b-5 may also need to be considered in the case of an outright gift. If the client-donor transfers securities by gift to a child-donee sharing the client-donor's household (or to any immediate family member sharing his or her household), the client-donor will generally be deemed to continue to own a pecuniary interest in the gifted shares by indirect ownership. Conversely, if a client-donor does not discuss the internal affairs of the company with the child-donee, and the donee does not live with the client-donor, the Rule 10b-5 insider trading rules likely will not apply. Short-swing profit rules of Section 16(b) of the Exchange Act also should not apply because gifts are exempt.

Donees of outright gifts of shares of a public company must also be aware of the securities law consequences of such gifts, which may restrict the timing, volume, and manner of the donee's future transactions with the gifted shares.

One of the major consequences to donees of gifted shares is that such shares may be "restricted securities" under the Securities Act, depending on how the donor obtained the shares. Shares originally acquired in a private offering will be restricted securities when gifted to the child-donee. Thus, if the child-donee wants to sell the restricted shares, he or she must do so in another exempt transaction under the Securities Act or in the public markets in compliance with Rule 144. Any other sale of the restricted securities will result in the child-donee being treated as an underwriter under Section 4(a)(1) of the Securities Act.

The child-donee may also be restricted in terms of the volume of shares that he or she can resell. Rule 144(e), the "amount sold" requirement, limits the volume of shares that can be resold by the child-donee to the greater of: (i) 1% of the company's outstanding shares or (ii) the average weekly trading volume of the company during the four weeks prior to the sale. Determining the volume of shares that the family member-donee can sell is further complicated if he or she is tacking on the client-donor's holding period for purposes of Rule 144(d), because the child-donee must aggregate his or her sales with sales by the client-donor during the applicable holding period.

The public company will also have reporting requirements as a result of an insider-client's outright gift of shares to a family member-donee. The current public information requirement of Rule 144(c) requires the public company to have "filed all required reports under Section 13 or 15(d) of the Exchange Act, as applicable," during the twelve months preceding any sale of the restricted securities.

Estate planners should be sure to make an insider-client aware of the consequences attendant to an outright gift of the insider-client's publicly traded securities. By doing so, estate planners can be sure that the non-tax issues are not prohibitive of achieving the client's tax objectives.

Lifetime Transfers in Trusts. Clients' estate planning goals are often best met through the use of trusts. For a high-net-worth insider, this frequently involves transferring shares of a public company to a trust for the benefit of the client and/or his or her family members. The securities law consequences may vary significantly for these transfers, as the applicable rules differ based on the type of trust and the trust terms.

Revocable Trusts. An *inter vivos* revocable trust is a common estate planning vehicle used as a will substitute to avoid probate, court supervision and public disclosures. If an insider-client funds his or her revocable trust with shares of a publicly traded common stock acquired in a private offering, the shares will be treated as "restricted securities" when held by the revocable trust. Effectively, this means that the client's revocable trust is subject to the same rules as the client.

If the client instead acquired the shares in the public market and the client is an affiliate of the company, the shares will be treated as control shares, which requires that any transfers made by the trust or its beneficiaries must adhere to Rule 144 while the client remains an affiliate. If the client subsequently sheds his or her affiliate status, the revocable trust and its beneficiaries can freely transfer the shares without adhering to the Rule 144 restrictions. However, the client does not shed his or her affiliate status at death,[13] and thus transfers made by the continuing trust after the client's death or by its beneficiaries must also adhere to Rule 144.

For purposes of Section 16 of the Exchange Act, when an insider-grantor exercises sole investment control over a revocable trust and has the power to revoke the trust without the consent of another person, the insider-grantor will be treated as the beneficial owner of the securities held in trust. Note, however, an important distinction: *the revocable trust itself* and *the transfer itself* of securities by the insider-grantor to the revocable trust will be exempt

11 The Investment Company Act is codified as amended at 15 U.S.C. section 80a et seq.

12 Transactions by insiders in the company's equity securities (including derivatives) that result in a change in beneficial ownership of the insider must be reported on a Form 4 within two business days following the transaction date. A Form 5 is only required from an insider when at least one transaction was not reported during the year because of an exemption or failure to report earlier. A Form 5 is due within 45 days after the end of the company's fiscal year.

13 Rule 144(d)(3)(vi).

from Section 16 because the transfer does not change the insider-grantor's pecuniary interest in the transferred securities. The insider-grantor must report the change of beneficial ownership (from direct ownership to indirect ownership) on a Form 4 or a Form 5 in order to comply with Section 16(a). By contrast, if the grantor of a revocable trust does not have sole investment control over the securities held in a revocable trust, the trustee of the trust (rather than the grantor) will report the trust-held securities.

Irrevocable Trusts. In contrast to a revocable trust, a client may wish to create an irrevocable trust to accomplish his or her estate planning goals. An irrevocable trust can either be a "grantor" trust or a "non-grantor" trust. In the case of a grantor trust, the client is deemed the "owner" of the trust for income-tax purposes and is responsible for the income tax on the trust's income, whereas in the case of a non-grantor trust, the trust itself is responsible for any tax liability generated by the trust's income. Grantor trusts are often preferable because the client pays the income taxes attributable to the grantor trust's property, which is effectively an additional tax-free gift to the grantor trust. While the income tax status of an irrevocable trust is not itself dispositive, it may help clarify the securities law impact of the insider-client's transfer of shares to an irrevocable trust.

For Rule 144 purposes, it is important to determine whether the trustee and the irrevocable trust are considered affiliates of the public company. In making these determinations, there are a few general rules. For one, even if an affiliate is the trustee or beneficiary of a trust, it does not necessarily mean that the trust itself will be deemed an affiliate. However, where an affiliate is both the trustee and beneficiary of a trust, the trust itself will be deemed an affiliate subject to Rule 144. In addition, if a trust holds 10% or more of the company's outstanding shares, the trust itself will generally be deemed an affiliate without regard to the status of the trustee.

The determination of a trustee's individual affiliate status is based on a totality of the facts and circumstances. If a client-affiliate transfers shares to an irrevocable trust, of which his or her child is the trustee, the trustee's affiliate status will be determined based on the relationship between the client-affiliate and the child-trustee. If the child is independent and not living with the client, the client's affiliate status will likely not be imputed to the child-trustee. However, if the child-trustee is dependent upon or lives with the client, the trustee will likely be deemed an affiliate. In that case, where the child-trustee is an affiliate and a beneficiary, the trust will also be deemed an affiliate.

In addition, the determination as to whether a grantor's affiliate status can be imputed to an irrevocable trust is based in part on the manner by which the securities are transferred. Where securities are sold to the trust by an affiliate in an exempt sale, such securities are restricted in the trust's hands, and the trust will be treated as an affiliate even if the grantor sheds affiliate status. However, if the securities are gifted, the trust is deemed an affiliate and the securities are restricted only while the grantor remains an affiliate. Ultimately, when a transfer is made by gift rather than by sale, the donee-trust steps into the donor's shoes for purposes of Rule 144.

When a client funds an irrevocable trust, an estate planner should also consider whether the irrevocable trust itself qualifies as an "accredited investor" or a "qualified purchaser" under the Securities Act or the Investment Advisers Act, respectively. The definitions of "accredited investor" and "qualified purchaser" are particularly important when advising high-net-worth clients, like private-equity and hedge-fund managers. Most funds desire to avoid registering with the SEC and, therefore, will admit only investors who satisfy one of these standards. As a result, when a fund manager transfers his or her fund interests to an irrevocable trust (regardless of whether the trust's grantor trust status), estate planners will want to ensure that the trust qualifies as either an accredited investor or a qualified purchaser.

When a fund manager-grantor transfers a fund interest to an irrevocable trust through a bona fide gift, the trust will generally not need to independently qualify as a qualified

14 Under section 2(a)(51)(A)(ii) of the Investment Company Act, an irrevocable trust created by a qualified purchaser grantor will be treated as a qualified purchaser, regardless of whether the trust was created for the specific purpose of acquiring the client's interests, if the trust owns at least $5 million in investments and has at least two beneficiaries who are "natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons."

15 Rule 501(a)(1) of Regulation D. The law is unclear, however, regarding whether Rule 501(a)(1) of Regulation D is satisfied when a trust company, rather than a bank, is designated as trustee. While policy reasons support this position, trust companies do not fall within the language of Rule 501(a)(1).

16 Rule 501(a)(7).

17 Nov. 26, 1983.

18 (1) The trust is a grantor trust for federal income tax purposes; (2) an accredited investor is the sole funding source of the trust; (3) an accredited investor is the trustee of the trust and has sole investment discretion; (4) the entire amount of the fund manager-grantor's contribution to the trust plus a fixed rate of return will be paid to the fund manager (or the fund manager's estate) before any payments can be made to the trust beneficiaries; and (5) creditors of the fund manager-grantor can reach the fund manager-grantor's interest in the trust at all times.

19 Here, "investment control" refers to the power to dispose of the shares rather than, for example, the power to remove and replace the trustee. See Arnold S. Jacobs, Section 16 of the Exchange Act section 2.134 (2010 ed.).

20 Oct. 16, 1997.

purchaser. When fund interests are transferred to a trust by gift, the fund manager-grantor's status as a qualified purchaser is imputed to the trust but accredited investor status is not. This distinction arises because the Securities Act registration requirements are generally applicable only when a fund interest is transferred in exchange for value, regardless of the grantor's trust status.

If the grantor's status is not imputed to the trust,[14] such as when an irrevocable trust purchases interests in a fund, an irrevocable trust may need to independently qualify as a qualified purchaser and an accredited investor. In order to be considered a "qualified purchaser," the trust must satisfy one of the requirements outlined above. An irrevocable trust will be considered an accredited investor if (a) a bank is serving as trustee of the trust[15] or (b) the trust owns assets in excess of $5 million, the trust was not formed for the specific purpose of acquiring the investment, and a "sophisticated person" directs the trust's investments.[16]

Moreover, under Rule 501(a)(8) of Regulation D and *Herbert S. Wander, SEC No-Action Letter*,[17] an irrevocable trust will independently be treated as an accredited investor if the fund manager-grantor is an accredited investor and if certain requirements are satisfied.[18] The trust discussed in *Wander* was a GRAT (as defined below); accordingly, GRATs are now a common type of trust that estate planners use to ensure that an irrevocable trust will be treated as an accredited investor.

GRATs. A grantor retained annuity trust (GRAT) is an estate planning device that permits a client to place property in trust and, subject to an interest factor, to pass the increase in value over the GRAT term to donees with minimal or no gift or estate tax. An annuity must be paid to the grantor during the GRAT term, and if assets held by the GRAT appreciate at a rate over and above the rate required by the IRS, the assets at the end of the term in excess of those needed to satisfy the annuity (i.e., the appreciation) will be distributed to the beneficiaries without further transfer tax consequences. However, if the assets held by the GRAT fail to outperform the required rate or, if the grantor dies during the term, the GRAT fails and the assets are returned to the grantor or the grantor's estate. Ultimately, GRATs transfer an asset's appreciation out of a client's estate with minimal, if any, transfer tax consequences.

Under Section 16 of the Exchange Act, the consequences for the GRAT itself and the GRAT beneficiaries are constant, regardless of the type of transaction in which the GRAT engages. The GRAT itself will only be required to report a transaction under Section 16 where the GRAT owns at least 10% of the company's outstanding shares immediately prior to said transaction. A GRAT beneficiary will only be required to report a transaction under Section 16 where the GRAT owns at least 10% of the company's outstanding shares immediately prior to said transaction, the beneficiary exercises "investment control"[19] over the shares in the GRAT (i.e., by serving as a co-trustee), and the transaction is deemed a purchase or sale by the GRAT.

By contrast, the Section 16 consequences for an insider-grantor are determined by the type and timing of the transaction. When the insider-grantor transfers shares to the GRAT, the shares change from being "directly" owned to being "indirectly owned." This transfer is exempt from Section 16 reporting as a change in the form of beneficial ownership. When shares are distributed by the GRAT to the insider-grantor, pursuant to the GRAT's annuity payment obligations, this distribution is exempt from Section 16 reporting as a change in the form of beneficial ownership (assuming none of the GRAT beneficiaries will have a pecuniary interest in the transferred shares). After the initial transfer, any reports filed by the insider-grantor should include his or her own shares and the distributed shares as *directly* owned by the insider-grantor and the GRAT-held shares as *indirectly* owned by the insider-grantor.

This particular set of facts was addressed in a 1997 SEC No Action Letter, *Peter J. Kight, SEC No Action Letter*.[20] In *Kight*, the SEC stated that when an insider serves as both the trustee and grantor of a GRAT, and the insider-grantor receives annuity payments from the GRAT during the term of the GRAT, the insider-grantor's contribution of securities to the trust and the trust's distribution of securities to the insider are both exempt from Section 16. The SEC reasoned that when an insider-grantor is both the trustee and sole annuitant of a GRAT, the insider-grantor continues to have the same pecuniary interest in the contributed securities, given the insider-grantor's continued investment control and right to annuity payments. As a result, the insider-grantor is not required to immediately report the funding interest in the GRAT. This rule applies even if someone other than the insider-grantor holds the remainder interest in the GRAT, so long as this remainderman does not exert investment control over the trust. As a result of *Kight*, so long as the insider-grantor is the sole trustee of the GRAT and no remainderman exerts control over investments, the transfer of shares from the insider-grantor to a two-year GRAT will be exempt from Section 16 reporting. Accordingly, when drafting a GRAT for an insider-grantor, an estate planner should ensure that the insider-grantor acts as the sole trustee during the GRAT term.

During the GRAT term, the consequences for the insider-grantor under Section 16 of the Exchange Act are also determined by (i) the type of transaction at issue (i.e., transactions between the GRAT and the insider-grantor or transactions between the GRAT and disinterested third parties) and (ii) when the transaction occurs (i.e., during the annuity period or after the annuity period but before the final GRAT distribution).

During the annuity period, the GRAT is treated as the insider-grantor's alter ego for Section 16 purposes (assuming no beneficiary has a pecuniary interest in the GRAT-held shares, which should be the case if the GRAT was drafted properly). Therefore, a transaction (other an annuity payment) between the GRAT and the insider-grantor is not reportable by the insider-grantor as a change of beneficial ownership. After the annuity period but before the final GRAT distribution, the GRAT is no longer treated as the insider-grantor's alter ego for Section 16 purposes. Therefore, a transaction between the GRAT and the insider-grantor would be reportable by the insider-grantor as a change of beneficial ownership.

During the annuity period, a transaction between the GRAT and a disinterested third party is reportable by the insider-grantor as an indirect transaction. After the annuity period but before the final GRAT distribution, the GRAT is no longer treated as the insider-grantor's alter ego for Section 16 purposes. Therefore, a transaction between the GRAT and a disinterested third party would be reportable by the insider-grantor as a change of beneficial ownership.

In 1998, the Southern District of New York addressed the Section 16 consequences for insider-grantors during the GRAT term in a landmark case, *Morales v. Quintiles*.[21] The court held that when an insider-grantor withdraws shares of a public company from a GRAT in exchange for a promissory note, this transaction is deemed a "purchase" by the insider-grantor and therefore it is subject to the Section 16(b) short-swing trading rules. The court reasoned that the withdrawal at issue was made at the discretion of the insider-grantor and that the insider-grantor subsequently made a profit when the share price increased following the withdrawal. The court distinguished this transaction, a voluntary act that may be timed to gain an advantage, from the annuity payments in *Kight*, where the amounts and payment dates were fixed at the time the GRAT was established. Therefore, insider-grantors who withdraw securities from a GRAT at non-fixed intervals should adhere to the Section 16 reporting requirements and should avoid making non-exempt sales within six months of such a withdrawal.

At the end of the annuity period, the GRAT ceases to be treated as the insider-grantor's alter ego for Section 16 purposes. Typically, at the end of the GRAT term, the insider-grantor will cease to act as trustee to avoid being considered to have investment control over the assets after the annuity period, even if the final annuity payment has not yet been made. At this time (or at any time when the insider-grantor ceases to be trustee of his or her GRAT) the insider-grantor may, but is not necessarily required to, file a Form 4 reporting the change of investment control. However, the insider-grantor must reflect that he no longer controls the shares held by the GRAT on his next required Form 4. The report filed by the insider-grantor should include in the insider-grantor's holdings the shares deemed to be indirectly owned through the GRAT, if they have not yet been distributed to the beneficiaries. The GRAT's distribution of shares to the beneficiaries, including to continuing trusts, will be reported by the insider-grantor as a gift on either a Form 4 or a Form 5, after which the shares will likely no longer be reported by the insider-grantor as

21 *Morales v. Quintiles Transnational Corp.*, 25 F. Supp. 2d 369 (S.D.N.Y. July 31, 1998), *reconsideration denied* (Nov. 19, 1998).

22 An IDGT may be structured as a "spousal lifetime access trust" (SLAT), which can be used to potentially give the grantor access to the asset by virtue of a distribution to the grantor's spouse.

23 While both transactions with IDGTs and GRATs seek to remove future appreciation from a client's estate, one significant planning difference to highlight between a sale to an IDGT and a GRAT is that a grantor can allocate the generation-skipping transfer (GST) tax exemption to an IDGT while the GST tax exemption cannot be allocated to a GRAT until the end of the "estate tax inclusion period" (typically, termination of the GRAT).

24 17 CFR section 240.16a-13.

indirectly owned by him. If the beneficiary is deemed the insider-grantor's alter ego for Section 16 purposes, a subsequent sale by the beneficiary could potentially be matched against a purchase by the insider-grantor.

Sales and Gifts to IDGTs. The use of intentionally defective grantor trusts (IDGTs) involves structuring an irrevocable trust so that the underlying assets are transferred out of the grantor's estate, but the grantor remains the owner of the assets for federal income tax purposes.[22] In this sense, the trust is "tax-effective" for estate tax purposes, but "tax-defective" for income tax purposes. A client may want to create an IDGT, rather than a GRAT or another vehicle, for many reasons, including potentially to transfer hard-to-value assets or to tax-efficiently gift to the client's grandchildren or more remote descendants. IDGTs can be funded by a client making an outright gift or by a client selling assets to the IDGT in exchange for a promissory note, either of which is intended to ensure the future appreciation on the asset inures to the benefit of the donee without further transfer tax consequences.[23]

Whether a transfer of assets to an IDGT is made by gift or by sale will affect how the insider-grantor is treated under Section 16 of the Exchange Act. If a client chooses to gift shares to the IDGT, the securities law consequences are fairly straightforward. When an insider gifts shares of a public company, in trust, to a third party, the gift will be exempt from the short-swing profit rule of Section 16(b).

However, the securities law consequences of transferring shares to an IDGT in a sale in exchange for a note are more complex. If a contribution of securities to an IDGT by an insider-grantor is treated as a "sale" for purposes of Section 16, such transfer may not qualify for an exemption under Section 16(a) or 16(b). In that case, the initial contribution will likely be treated as a disposition of the shares for an amount equal to the shares' fair market value less the value of any installment payments received under the note. If an insider-grantor receives note payments and exercises investment control over the trust assets, the insider-grantor may be deemed to have "beneficial ownership" of the shares held by the trust. Accordingly, any contribution of such shares

Estate planners with charitable clients who are insiders should consider not only the tax impact of each vehicle, but also the securities law consequences of the various options.

to the IDGT will likely be considered a change in the insider-grantor's beneficial ownership and will need to be reported on a Form 4 or a Form 5 by the insider-grantor. To avoid potential short-swing liability under Section 16(b), the insider-grantor should refrain from making non-exempt purchases of the company's shares within six months of any contribution of shares to the IDGT.

If the client chooses to transfer shares into the IDGT by sale, the estate planner can simplify the client's reporting obligations and minimize potential short-swing liability by advising the client-insider not to retain investment control over the assets of the IDGT that may lead to the client being deemed to have beneficial ownership over the trust assets. This may be done by naming someone else as trustee or, in some cases, prohibiting the client from removing and replacing trustees of the IDGT. This advice is particularly viable if the IDGT already has cash or other assets that can be given in consideration for the sale because the absence of a continuing note from the IDGT to the client will minimize the risk that the client will be deemed to have beneficial ownership over the shares.

Decanting. It is becoming increasingly common for clients to reconsider the terms of existing irrevocable trusts. Estate planners, therefore, are frequently relying on decanting to distribute assets from an existing trust to a new trust with more favorable terms, such as advantageous governing law or desirable distribution or investment provisions.

When a trustee transfers securities from one trust to another trust without consideration, and the material terms of both trusts are identical, the transfer may be exempt from the requirements of Section 16 as a "transaction . . . that effects only a change in the form of beneficial ownership without changing a person's pecuniary interest."[24] Thus, if a trustee transfers securities from one trust to another in order to extend the term of a trust, the transfer is likely exempt from Section 16. Meanwhile, a decanting to change the class of beneficiaries may be considered a change of beneficial ownership subject to Section 16.

The threshold issues are whether the transfer is deemed a sale or purchase for Section 16 and whether there are arguably any changes to any person's pecuniary interests as a result of the transfer. No consideration is exchanged in a decanting, which helps reduce the risk that a client-insider will be subject to Section 16 upon a decanting. However, an estate planner who wants to ensure that a client-insider remains exempt from Section 16 should structure the decanting so that all beneficiaries have identical pecuniary interests in the new trust and the old trust.[25]

Substitution of Property. By retaining the power to substitute assets in a non-fiduciary capacity, a client can achieve grantor trust status without affecting the economic interests of the trust beneficiaries. If the trustee has a fiduciary obligation to ensure that the properties exchanged are, in fact, of equal value, retaining this power will not cause the trust assets to be included in the client's estate.[26] This power to substitute may also provide the client-grantor with an opportunity to obtain a basis step-up at death by reacquiring low-basis assets prior to death in exchange for cash or other high-basis assets. If the client, who is an insider for purposes of Section 16 of the Exchange Act, exercises his or her power to substitute securities for property of equivalent value, it would likely be deemed a transfer for consideration under *Quintiles*.[27] As a result, the transfer would not qualify for an exemption under Section 16(a) or 16(b), and the transfer would be reportable on a Form 4 and subject to the short-swing profit rule. Therefore, where the client is an insider, an estate planner must weigh the tax and non-tax implications (i.e., the reporting requirements and associated costs) of exercising a power of substitution over an IDGT.

Issues Relating to Trustees. Estate planners should also consider the securities law consequences for trustees of irrevocable trusts whenever such trusts own securities. This is particularly true where a trust owns securities in a public company and the trustee is an insider of that company. Such an insider-trustee may be deemed to have a pecuniary interest in the company shares held by the trust for various reasons, including, for example, (a) the trustee is a direct or indirect beneficiary of the trust, (b) the trustee is paid a fee based on the performance of the trust's portfolio, or (c) the trustee exercises investment control.

Estate planners should also be aware that there is significant uncertainty regarding the securities law consequences of an individual holding the power to remove and replace the trustees of a trust. The SEC has held that the power to remove a trustee without the approval of the trust beneficiaries is not the same as the power to revoke a trust.[28] Thus, a grantor who retains the power solely to remove a trustee is not deemed a beneficial owner *per se*. However, it is unknown whether one who can both remove a trustee and replace that trustee would be deemed a beneficial owner.

As a result of this uncertainty, a cautious estate planner might advise an insider-grantor to report his retained power to remove the trustee on a Form 4 to ensure that the insider-grantor complies with any possible reporting requirements. To minimize the risk that the insider-grantor is deemed a beneficial owner or is deemed to have admitted ownership, he should consider including on the Form 4 that he disclaims any ownership of the subject shares for purposes of reporting under Section 16 of the Exchange Act, except to the extent of his pecuniary interest.

Testamentary Transfers. Testamentary transfers, whether as outright devises or as dispositions in further trust, have separate securities law consequences that estate planners must consider when advising insider-clients, their estates, and the beneficiaries of those estates.

In order to illustrate some of these issues, consider a client who dies as a director of a public company, but who owned less than 10% of the company's outstanding shares. This client was an insider of that company for purposes of the Exchange Act and an affiliate for purposes of Rule 144(a) of the Securities Act. Assume also that all of the shares held by the client were acquired in a private placement.

Under Rule 144(a), the client's affiliate status is inherited by the client's estate. Similarly, if the client's shares in the company are devised outright to a family member, the family member will be deemed an affiliate as well. This imposes reporting requirements under Rule 144 on both the estate and the family member devisee.

Regardless of the client's affiliate status, restricted securities under the Securities Act remain restricted upon passing to a purchaser's estate or devisees. However, Rule 144(d)(3)(vii) provides a safe harbor from the usual requirements of Rule 144 for estates and devisees who are not affiliates (i.e., those who receive restricted securities from a non-affil-

25 If an estate planner is concerned about the Section 16 implications of a trust decanting, a safe strategy is to avoid any similar transactions for a period of six months and to report the transfer on a Form 4.

26 Rev. Rul. 2008-22, modified by Announcement 2008-46.

27 *Morales v. Quintiles Transnational Corp.*, 25 F. Supp. 2d 369 (S.D.N.Y. July 31, 1998), *reconsideration denied* (Nov. 19, 1998).

28 Ownership Reports and Trading By Officers, Directors and Principal Security Holders, Exchange Act Release No. 34-28869, 48 SEC Docket 255 (Feb. 26, 1991).

29 A "vertical slice" is the term for a transaction frequently undertaken with interests in private equity vehicles to avoid running afoul of deemed gift issues under I.R.C. Section 2701. If a client transferred only his or her carried interest in a fund, I.R.C. Section 2701 would deem the client to have transferred *all* of his or her interest in the fund for gift-tax purposes. In a vertical slice, the transferor avoids this adverse treatment by transferring a portion of carried interest to the donee, but also by transferring to the donee a proportionate amount of any other equity interest in the fund. Pursuant to I.R.C. Section 2701(a)(2)(c), such a transfer of a vertical slice is not subject to the general rule of I.R.C. Section 2701.

30 See Priv. Ltr. Rul. 9511041 (Dec. 21, 1994), Priv. Ltr. Rul. 9825031 (Mar. 24, 1998), and Priv. Ltr. Rul. 9320016 (Feb. 17, 1993).

iate decedent). This safe harbor does not apply to trusts though. Accordingly, in some cases, estate planners might advise an insider-client to not fund his or her revocable trust with restricted securities in order to ensure that the shares pass through the client's estate to the estate's beneficiaries (which presumably may include the client's revocable trust), and exempt the beneficiaries from Rule 144.

Section 16 and Rule 10b-5 are more straightforward. Transfers of securities by will are exempt from the requirements of Section 16. In addition, if the client did not discuss nonpublic company affairs with the devisee, and the devisee did not obtain such information prior to the sale of shares by the estate, the Rule 10b-5 insider trading rules will not apply to an outright devise to the family member.

Estate planners should also consider the affiliate status and securities law consequences of naming certain persons as executor in the client's estate plan. Naming an affiliate as an executor and beneficiary of the estate will always make the estate an affiliate subject to the requirements of Rule 144. However, naming an affiliate as an executor will not necessarily make the estate an affiliate. Estate planners should also advise insider clients not to name a "broker-dealer" under Section 15 of the Exchange Act as the executor, because there may be self-dealing issues and internal policies that prevent the broker-dealer from carrying out the role.

In addition, the "accredited investor" and "qualified purchaser" issues discussed previously, arise when drafting testamentary instruments for clients who own exempt securities, such as private equity and hedge fund managers. If such a client has a will or a revocable trust that creates a new continuing trust upon the client's death, the continuing trust will inherit the decedent's qualified purchaser status, but will not inherit the decedent's accredited investor status. Accordingly, an estate planner should consider advising the client to name an accredited investor as the fiduciary to ensure accredited investor status.

Transfers of Interests in Limited Partnerships and Limited Liability Companies. Many clients have interests in limited partnerships (LPs) or limited liability companies (LLCs) that they would like to utilize in their estate planning. Whenever an estate planner is advising on transactions involving these interests, the estate planner should be sure to structure the transaction to be exempt from registration requirements, to the extent possible, and to be cognizant of the potential securities law consequences.

A limited partner's interest in a limited partnership is always considered a security because a limited partner cannot participate in the management of the limited partnership. By contrast, a general partner's interest is generally not deemed a security under the *Howey* test because general partners play an active role in management of the limited partnership. Since transfers of LP and LLC interests are typically nonpublic and involve only a small number of parties with preexisting relationships, such transactions are generally exempt from registration requirements under Section 4(a)(2) of the Securities Act. Many standard estate planning transactions involving LPs and LLCs, such as a "vertical slice" transaction entered into by a client seeking to transfer a portion of his or her carried interest in a private equity fund,[29] may not implicate Section 16 of the Exchange Act if the securities in the underlying investment always remain owned by the private equity fund.

Transfers to Charitable Entities. High-net-worth clients are frequently charitably inclined and want to utilize various estate planning vehicles and corporate structures to accomplish their charitable goals while utilizing the maximum available charitable deductions for income, gift, and estate tax purposes.

One of the most common methods for accomplishing a client's charitable goals is to create a private foundation and transfer assets to that foundation. Generally, transfers to a private foundation provide individual taxpayers with an income tax deduction limited to the taxpayer's basis in the donated property. However, under Section 170(e)(5), the taxpayer may deduct the full fair-market value of "qualified appreciated stock" gifted to a foundation. To be qualified is appreciated stock, the stock must meet three requirements: (i) it must have market quotations readily available on an established securities market; (ii) if the stock were sold, it must produce long-term capital gain; and (iii) taken together, all contributions of the stock by the donor and related parties must comprise less than 10% of the company's outstanding stock.

The first requirement often presents special issues for insiders of public companies because if a transferred stock would be restricted pursuant to federal securities law, then the stock will not be considered by the IRS to have market quotations readily available on an established securities market. As a result, the restricted stock would only be deductible to the extent of its income tax basis, thereby eliminating qualified appreciated stock treatment.

Over the years, the IRS has issued a series of private letter rulings regarding whether certain securities satisfy the requirements of qualified appreciated stock.[30] For example, the IRS has held that stock that is subject to Rule 144 but for which the holding period has expired and the donor has agreed to limit his or her sales so as not to restrict sales by the foundation under Rule 144 satisfies the three requirements.[31] By contrast, the IRS has determined that Rule 144 stock for which the holding period has not yet run does not satisfy the three requirements.[32]

Accordingly, if an insider client wants to contribute restricted securities while maximizing his or her available income tax deduction, he or she should seek to use shares where the holding period under Rule 144 has expired and enter into a pledge agreement or other written instrument with the foundation. The agreement should provide that the client, individually, as fiduciary, and in any other capacities, agrees on his or her own behalf and on behalf of his or her spouse, related parties, and successors, that such persons will not dispose of or otherwise participate in the disposition of any shares in the company to the extent that such disposition would limit the foundation's ability to dispose of the gifted shares. The agreement should also provide that the client will take all reasonable steps, at his or her own expense, to ensure that transferred shares are freely disposable by the foundation, including obtaining an opinion of counsel to that effect.

Clients may also utilize charitable trusts, such as a charitable remainder trust (CRT) or a charitable lead trust (CLT), to accomplish their charitable goals. The same income-tax deduction rules that apply to contributions to charitable trusts apply to direct contributions to charitable organizations. Accordingly, the qualified appreciated stock rules relating to the allowable income tax deductions discussed above are only applicable to transfers to private foundations. These rules therefore do not apply to transfers to charitable trusts unless the charitable beneficiary is a private foundation.

Rule 144 may be implicated by a client's use of a charitable trust. Restricted securities held by clients who acquired shares of a company in an exempt transaction, such as a founder of a company, will continue to be restricted when transferred to a charitable trust. Moreover, if the client is an affiliate of the company for Rule 144 purposes, the shares contributed to a charitable trust may only be resold in accordance with the Rule 144 requirements.

Determining the applicability of Section 16 of the Exchange Act to CRTs and CLTs is similar to the Section 16 analysis applicable to GRATs, discussed previously, subject to a few exceptions. Like the Section 16 analysis for GRATs, Kight should apply in the context of CRTs such that when an insider-grantor serves as both the trustee and sole annuitant or sole unitrust recipient of a CRT, both the insider-grantor's contribution of securities to the trust and the CRT's distribution of securities to the insider-grantor are exempt from the requirements of Section 16. However, during the term of the CRT, any purchases or sales by the CRT of shares of the publicly traded company of which the insider-grantor is an insider are reportable by the insider-grantor individually. At the end of the trust term, when the shares are distributed to the charitable remainder beneficiary, the insider-grantor should report the distribution on a Form 4 or a Form 5 as a gift (even though the taxable termination of the charitable trust is not a taxable gift for federal estate tax purposes).

Unlike the Section 16 analyses for GRATs and CRTs, *Kight* does not apply in the context of transfers to CLTs. When an insider-grantor contributes publicly traded common stock to a CLT, this contribution is deemed a change of the insider-grantor's beneficial ownership even where the insider-grantor is a trustee of the CLT. Therefore, the insider-grantor must report this initial contribution on a Form 4 or a Form 5. Moreover, if the insider-grantor is a trustee of the CLT, and the remaindermen of the CLT are family members of the insider-grantor, the insider-grantor will likely be required to report both the initial contribution of shares to the CLT and any subsequent purchases or sales of such shares by the CLT.

Given the differing treatment of private foundations, CRTs and CLTs under the securities laws, estate planners with charitable clients who are insiders should consider not only the tax impact of each vehicle, but also the securities law consequences of the various options.

Conclusion

An understanding of securities law is essential for any estate planner, especially when advising high-net-worth individuals and insiders of public companies. When an estate planner can identify potential securities law issues, he or she can implement wealth transfer transactions and structures that allow clients to achieve their tax and non-tax objectives, including minimizing reporting requirements, short-swing liability, and insider-trading liability.

In connection with an estate-related transfer, a transferor must consider whether the proposed transfer involves a "sale" of "securities," whether the sale would be viewed as a public offering subject to registration under the Securities Act and, if so, whether there is an available exemption from the Section 5 registration requirements. ■

31 *Id.*

32 Priv. Ltr. Rul. 9915053 (Jan. 11, 1999).