

Alert | Tax/Entertainment & Media



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Estate Tax Issues for Deceased Artists and Entertainers

During the first quarter of 2020, some notable artists, athletes, and entertainers succumbed to the global Coronavirus Disease 2019 (COVID-19) pandemic and other tragic causes. The estates of deceased artists and entertainers have unique estate tax implications and their estate tax returns are frequently targeted for audit by the Internal Revenue Service (IRS). Because many artists' deaths have been sudden, they may have undertaken little or no estate planning. The heirs, executors, and administrators of those artists who die without estate plans often experience controversies with creditors, family members, and business associates, as well as the taxing authorities. This alert identifies some of the estate tax issues deceased artists' estates can encounter.

Dying Without a Will or Failing to Have an Up-to-Date Will

Historically, many well-known celebrities have died without wills. When someone dies intestate, state law governs the disposition of the decedent's assets. There are other celebrities who died and had wills, but failed to keep their estate plans up to date. Litigation that ensues as a result of these situations may be expensive, time-consuming, and may result in negative publicity.

In addition to costly probate litigation, the failure to leave a will may have estate tax implications. For example, when a person dies intestate, state law may require that the decedent's property be divided among the surviving spouse and children. In this scenario, the decedent's estate may not be able to take

full advantage of the unlimited marital deduction to defer estate tax liability until the death of the surviving spouse.

Domicile is also an issue for artists and entertainers who are often highly mobile, which may make it difficult to determine their domicile for tax purposes. A decedent's estate planning documents may be probative on this issue for a deceased artist who lived in multiple locations. The decedent's domicile is significant because of the implications for state taxation. Not all states impose estate or inheritance taxes but for those that do, having an up-to-date estate plan may prevent litigation and reduce the artist's overall estate tax liability.

Valuation of Unique Intellectual Property Interests

Entertainers often own unique intellectual property interests, including royalty interests and the right of publicity (i.e., one's name and likeness). Estate tax is imposed on the gross value of a decedent's property at the moment of death. The valuation of any property, including the intellectual property, for estate tax purposes depends on market conditions and other factors that a hypothetical willing buyer and willing seller would have been expected to know at the moment of the artist's death. As a general rule, post-death events are only considered in determining value to the extent that they were reasonably foreseeable on the valuation date. When a major celebrity dies, the circumstances surrounding the death may have the effect of substantially increasing (or decreasing) the value of his or her intellectual property rights.

The IRS closely scrutinizes the valuation of these intellectual property assets and often challenges them for estate tax purposes, causing expensive high-profile audits and litigation for artists. I.R.M. § 4.48.5 provides general guidelines about the valuation of intangible assets. I.R.M. § 4.48.5(7) identifies multiple valuation methods that may apply to intangible assets. The IRS has taken the position that only two of these methods are appropriate for intellectual property owned by deceased celebrities: the market approach and the income approach. The market approach identifies sales of similar intangible assets in similar market conditions. This method requires an active market for similar intangible assets. Under the income approach, value is projected based on the net present value of future revenue less costs. This method requires estimates of the amount and duration of future earnings, as well as the risks associated with the revenue stream. There is little legal guidance about how the valuation methodologies should be applied to the intellectual property owned by deceased artists. As a result, these cases have unpredictable outcomes. Some of the common valuation issues are summarized below.

Royalties

Music catalogs, copyrights, and film and television interests are difficult to value because there are relatively few sales and those that do exist are rarely comparable. A common technique for valuing these assets is to project the future income stream from the intellectual property and then discount it to present value.

The publicity surrounding an artist's death may lead to a renewed interest in the artist's work. As a result, there may be a post-mortem spike in royalties, which slows over time. The amount of the post-mortem spike varies widely from artist to artist. The IRS takes the position that a post-mortem royalty spike is reasonably foreseeable at the moment of the artist's death and, therefore, this factor must be taken into account for purposes of valuing the deceased artist's royalty interests. To determine what royalty spike was reasonably foreseeable on the date of death, a valuation expert may rely on data from other artists who may not be comparable in terms of career, record sales, popularity, musical genre, time of stardom, etc. Moreover, the IRS will have access to actual data if it audits the deceased artist's estate tax return. If the estate experienced a significant increase in royalties after death (a common effect because of a

nostalgic public), it may be difficult to argue that a lower rate should be applied for purposes of valuing the royalty interests on the date of death.

Valuing royalty interests is further complicated when a deceased artist has unreleased work at the time of death. An artist's unreleased work may not be of the same level or quality as his released work. Also, in some cases, an artist's estate may be concerned that releasing lower quality recordings may have a detrimental effect on the value of the artist's existing music. An estate can anticipate having a debate about the quantity and quality of unreleased recordings and their impact on the value of the deceased artist's music catalog.

Under U.S. copyright law, a musician or songwriter may have an opportunity to regain ownership of their works 35 years after they are transferred to third parties, such as record companies and music publishers. The law is uncertain in this area. In lieu of exercising their termination rights, many artists may negotiate a higher royalty rate for these recordings. This raises the issue of how the artist's termination rights will affect the value of his royalty interests for estate tax purposes.

Name and Likeness

The right of publicity is the right of an individual to own and control the use of his or her name, likeness, or voice. Right of publicity laws prevent the unauthorized commercial use of an individual's name, likeness, or voice and confer on the individual a right to license them for commercial benefit. This right of publicity is governed by state law. Not all states recognize a post-mortem right of publicity. Therefore, an artist's domicile at the time of death will determine whether the right of publicity is includible in his gross estate for estate tax purposes.

The only reported case dealing with the valuation of the right of publicity in the context of the estate tax is the Estate of Andrews v. U.S. 850 F. Supp. 1279 (E.D. Va. 1994). In this case, a best-selling author died shortly after she signed a contract with her publisher to write two novels in exchange for a \$3,000,000 advance payable in two installments. Following her death, the publishing company hired a ghostwriter and ultimately published five best-selling novels under her name. The IRS audited the estate tax return and determined that the estate should have included the deceased author's right of publicity in its gross estate. Its valuation expert asserted that the right to use the author's name was worth \$1,244,910.84 on the date of death. The district court agreed that the right of publicity was includible in the author's estate for estate tax purposes. In determining value, the court applied a two-step analysis: (i) it identified the facts that would be known on the date of death; and (ii) determined how a willing buyer and willing seller would apply those facts in a hypothetical sale. Using the publishing contract as a starting place, the court determined that, on the date of the author's death, it was reasonably foreseeable that the publishing company would try to find a ghostwriter to do one manuscript and that it would only continue if the first ghostwriting project was successful. Based on its own assessment of the risk and costs of a ghostwriting project, the district court arrived at a different value of \$703,000. The Estate of Andrews demonstrates the lack of predictability in valuing name and likeness rights. As a result, this remains a controversial issue.

Applying the market approach is difficult because there are very few public sales involving name and likeness rights. The public sales that exist (i.e., Elvis Presley, Marilyn Monroe and Bob Marley) involve celebrities with extensive licensing histories. Few artists are comparable in terms of longevity and notoriety, and therefore, relying on these sales may significantly inflate the value.

The income approach to valuation involves a discounted cash flow analysis of future revenue streams. Applying this approach is more difficult when an artist has no licensing history. IRS experts may

disregard the lack of licensing history even if it is due to a lack of opportunity, poor publicity or a deliberate choice on the part of the artist. In this circumstance, the appraiser may have to speculate about what licensing projects would be available to the deceased artist (e.g., health and beauty, apparel, fragrance, etc.) and project the royalty rates based on limited data. The publicly-available data regarding celebrity licensing agreements may be inaccurate. Industry experts may have access to actual licensing agreements, but non-disclosure agreements generally prevent them from disclosing that data. Even when reliable data is found, an appropriate discount must be applied to account for the risk involved in developing a new brand from scratch where the deceased celebrity is unavailable for public appearances and endorsements.

Due to the speculative nature of the valuation methodology, appraisers often reach different conclusions about the value of an artist's name and likeness. Rebutting the IRS's valuation adjustments may require the estate to divulge private information about the artist that could damage the artist's brand. Therefore, it is important to obtain a quality appraisal from an appraiser who has specific expertise on licensing issues.

Liquidity and Penalty Issues

In addition to estate tax liability, the IRS may impose a penalty equal to 20% of a substantial estate or gift tax valuation understatement under I.R.C. § 6662(g). A substantial estate or gift tax valuation understatement exists where the value of property reported on an estate or gift tax return is 65% or less of its correct value and the underpayment attributable to such valuation understatement exceeds \$5,000. The penalty is increased to 40% of the understatement where there is a "gross valuation misstatement." A "gross valuation misstatement" occurs when the property is reported at a value less than 40% of its correct value. The penalty may be abated if it can be established that the understatement is due to reasonable cause. The reliance on a qualified appraiser may constitute reasonable cause, underscoring the importance of obtaining a high-quality appraisal. For decedents dying in 2020, the federal estate tax applies at a rate of 40% for estates exceeding \$11,580,000 in value. If the IRS asserts significant estate tax adjustments and penalties, a deceased artist's estate may not have the liquidity to satisfy its estate tax obligations.

Conclusion

The death of an artist or entertainer has significant estate tax implications. Litigating these issues may be costly and time consuming and the resulting publicity may damage a deceased artist's brand. Artists may be able to prevent these issues by effective planning during their lifetimes. Where advanced planning is impossible, the estate should consult with tax advisors and appraisers who have specific expertise in these issues at the time the estate tax return is being prepared.

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