Max's Taxes: A Tax-Based Analysis of Pet Trusts

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MAX’S TAXES:¹

A TAX-BASED ANALYSIS OF PET TRUSTS²

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I. INTRODUCTION

Humans and charities are no longer the primary entities many individuals wish to benefit upon death. Instead, there is a growing interest in providing for Rover, Fluffy, and Polly, that is, our beloved pets. There has been a recent surge of public interest in pet planning as high-profile individuals have died with significant provisions in their wills or trusts for the benefit of their animals. For example, when Leona Helmsley died in 2007, we learned that she left $12 million in her will to a trust to benefit her white Maltese dog named Trouble. When singer Dusty Springfield died, there were reports that her will contained provisions in favor of her cat, Nicholas, such as for his bed to be lined with Dusty’s nightgowns, Dusty’s recordings to be played when Nicholas retired to bed each evening, and that Nicholas be fed imported baby


food. Carlotta Liebenstein’s passage of her $80 million estate to her dog, Gunther, also made headlines. Even earlier, when Doris Duke, the sole heir to Baron Buck Duke who built Duke University and started the American Tobacco Company, died, she left $100,000 in trust for the benefit of her pet poodle, Minnie.

This increase in the special estate planning needs of pet owners is reflected by legal scholarship, continuing legal education programs, and legislative action in the pet trust arena. But little time has been devoted to the tax ramifications of pet trusts although a brief discussions are included in several articles. The purpose of this article is to fill this gap and give practitioners guidance how pet trusts are treated for tax purposes and to suggest to Congress how the Internal Revenue Code should be amended to clarify taxation issues. Part II provides basic

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9 See Doing Well By Doing Good in Animal Law Cases, Gonzaga University School of Law CLE (2008) (examining estate planning with companion animals); Gerry W. Beyer, Estate Planning for Animal Lovers, The 18th Annual Festival of Legal Learning, University of North Carolina School of Law (2008) (providing guidance on how to protect pet animals after the owner’s disability or death).


background information on pet trusts before addressing the tax issues.\textsuperscript{12} Parts III-V examine the income, estate, and gift tax consequences for a pet trust on the federal and state levels.\textsuperscript{13} To assist in this process, “AJ” and “Pat,” two hypothetical clients, will be used to provide a basis for the existing and proposed rules: AJ is the wealthy pet owner of Max, a dog, and Charlie, a horse; Pat is an average wage-earner pet owner of Socks, a cat. Parts III-V apply these implications to AJ’s and Pat’s pet-trust needs.\textsuperscript{14}

\section*{II. BACKGROUND OF PET TRUSTS}

\subsection*{1. History}

Providing for pet animals has a long and interesting history.\textsuperscript{15} For example, in the 1889 English case of \textit{In re Dean}, the court upheld a testamentary gift for the maintenance of the testator’s horses and hound dogs.\textsuperscript{16} The first reported case in the United States dealing with a gift for the benefit of a specific animal was not decided until 1923 where in \textit{Willett v. Willett} Kentucky’s highest court determined that the testator’s desire to care for her pet dog was a humane purpose and thus valid.\textsuperscript{17}

This auspicious beginning, however, was not generally followed by subsequent United States cases.\textsuperscript{18} Attempted gifts in favor of specific animals usually failed for a variety of reasons,

\bibitem{12} See discussion \textit{infra} Part II.
\bibitem{13} See discussion \textit{infra} Parts III-V.
\bibitem{14} See discussion \textit{infra} Parts III-V.
\bibitem{16} \textit{In re Dean}, 41 Ch. D. 552 (1889).
\bibitem{17} \textit{Willett v. Willett}, 247 S.W. 739, 741 (Ky. 1923).
\bibitem{18} See, \textit{e.g.}, \textit{In re} Estate of Russell, 444 P.2d 353, 355-63 (Cal. 1968).
such as for being in violation of the Rule Against Perpetuities because the measuring life was not human such as for being in violation of the Rule Against Perpetuities because the measuring life was not human\(^\text{19}\) or for being an unenforceable honorary trust because it lacked a human or legal entity as a beneficiary who would have standing to enforce the trust.\(^\text{20}\)

### 2. The Traditional Pet Trust

To counter these problems, astute estate planners fashioned the technique which has come to be known as the *traditional pet trust* in which the pet owner creates a trust in favor of a human beneficiary (the pet’s caregiver) and then requires the trustee to make distributions to the beneficiary to cover the pet’s expenses provided the beneficiary is taking proper care of the pet.\(^\text{21}\)

This technique avoids the two traditional problems with gifts to benefit pet animals because the actual beneficiary is a human for both measuring life and for standing purposes.

Even though the traditional pet trust provides a mechanism for a pet owner to provide for his or her pets, this technique requires the pet owner to locate not only a competent attorney specializing in estate planning, but also one with pet trust experience. Many courts were less than receptive to gifts that benefited animals unless the trusts were carefully crafted.\(^\text{22}\) This limited the ability of many clients, especially those with modest estates, to provide for their beloved companions.

What the law needed was a way of validating a simple gift such as “I leave $1,000 for the

\(^{19}\) *See, e.g.*, Note, Validity of Trusts in Favor of Animals, 42 YALE L.J. 1290 (1933) (citing *In re Howell’s Estate*, 260 N.Y.S. 598 (Sup. Ct. 1932), modified, 261 N.Y.S. 859 (1933)).

\(^{20}\) *See, e.g.*, RESTATEMENT (SECOND) OF TRUSTS §112 (1957) (“A trust is not created unless there is a beneficiary who is definitely ascertained at the time of the creation of the trust or definitely ascertainable within the period of the rule against perpetuities.”); see also CAL. PROB. CODE §15205(a) (West 1991) (providing that “[a] trust, other than a charitable trust, is created only if there is a beneficiary”); In re Estate of Russell, 444 P.2d 353 (Cal. 1968).


\(^{22}\) *See, e.g.*, Beyer Pet Animals, *supra* note 8, at 629-35.
care of my dog, Spike” and providing default terms so that the gift could take effect as most likely intended by the pet owner. In other words, the law needed a pet equivalent of the Uniform Gifts/Transfers to Minors Act custodianships which had already gained widespread acceptance.23

3. The Statutory Pet Trust

A seed was needed to start a change in the law and the planting of that seed occurred in 1990 when the National Conference of Commissioners on Uniform State Laws added § 2-907 to the Uniform Probate Code validating a trust with a duration of 21 years or less which provides for the care of a designated domestic or pet animal and the animal’s offspring.24 Three years later, the Commissioners amended § 2-907 making two significant changes.25 First, the twenty-one year duration was eliminated to permit a pet trust to be used for long-lived animals such as horses and parrots26 and second, the pet owner could no longer provide for “grandchildren pets,” that is, the animal’s offspring.27

State legislatures were reluctant to adopt the UPC provision with less than half of the UPC states adopting the pet trust section.28 As a result, this new statutory pet trust technique was


28 See the following states as adopting § 2-907 to their UPC: ALASKA STAT. § 13.12.907 (West 2008); ARIZ. REV. STAT. ANN. § 14-2907 (West 2008); COLO. REV. STAT. § 15-11-901 (West 2008); FLA. STAT. ANN. § 736.0408 (West 2008); IOWA CODE § 633A.2105 (West 2008); MICH. COMP. LAWS § 700.2722 (West 2008); MO. REV. STAT. § 456.4-408 (West 2008); MONT. CODE ANN. § 72-2-1017 (West 2008); NEV. REV. STAT. § 163.0075 (West 2008); N.J. STAT. ANN. § 3B:11-38 (West 2008); N.M. STAT. § 45-2-907 (West 2008); N. Y. EST. POWERS & TRUSTS LAW § 7-8.1 (West 2008); N.C. GEN. STAT. § 36C-4-408
available in fifteen states (the enacting states and those with free-standing statutes based on the UPC).

The seed received significant watering and fertilizing when authorization for statutory pet trusts was included in § 408 of the Uniform Trust Code which the National Conference of Commissioners on Uniform States Laws adopted in 2000. Unlike the UPC, the UTC gained widespread acceptance with enactment in twenty states, the District of Columbia, and introduction in 2008 in Connecticut, Massachusetts, and Oklahoma, often without the legislature giving independent consideration to the “hidden” authorization of statutory pet trusts.

At the insistence of various animal welfare organizations and because of the positive publicity that legislators and governors receive from enacting and approving such provisions, approximately ten other states have authorized statutory pet trusts, either by following the UPC or UTC models or by designing their own statutes. Approximately forty states and the District

(West 2008); OR. REV. STAT. § 130.185 (West 2008); UTAH CODE ANN. § 75-2-1001 (West 2008); WASH. REV. CODE §§ 11.118.005-.110 (West 2008).

29 See sources cited supra note 28.


32 See Beyer website, supra note 30; see also (listing the following jurisdictions: Florida, Idaho, Indiana, Iowa, Nevada, New Jersey, New York, Rhode Island, Texas, and Washington).
of Columbia now have legislation authorizing statutory pet trusts.\textsuperscript{33}

\section*{4. Honorary Pet Trust}

A few states have enacted statutes dealing with pet trusts but do not provide for their enforcement.\textsuperscript{34} In these states, the trustee may carry out a non-traditional pet trust but is not required to do so.\textsuperscript{35} Use of honorary pet trusts is not recommended because of disadvantages and the availability of traditional or statutory pet trust statutes in many jurisdictions.\textsuperscript{36} Ambiguity can be removed by specifying the settlor’s wishes in a traditional or statutory pet trust.\textsuperscript{37}


\textsuperscript{34} Cave, \textit{supra} note 24, at 650-51 (listing the states of California (which now follows § 408 of the UTC), Missouri (which now follows § 408 of the Uniform Trust Code), Tennessee, and Wisconsin); see also TENN. CODE ANN. § 35-15-408 (2007) and WIS. STAT. § 701.11 (2001).

\textsuperscript{35} See CAL. § 15212, TENN. § 35-15-408, and WIS. § 701.11.

\textsuperscript{36} See \textit{supra} Parts II.2-II.3.

\textsuperscript{37} See \textit{supra} Parts II.2-II.3.
Additionally, an honorary trust might be at a disadvantage under the current tax code.\textsuperscript{38}

5. \textit{Which Type of Pet Trust is Better?}

Many pet owners will prefer the traditional pet trust because it gives the pet owner the ability to control the pet’s care rather than having a statute or a court determine what the pet needs. For example, the owner may specify who manages the property (the trustee), the pet’s caregiver (the beneficiary), what type of expenses relating to the pet the trustee will pay, the type of care the animal will receive, what happens if the beneficiary can no longer care for the animal, and the disposition of the pet after the pet dies.

If the client, however, has a modest estate or is not interested in supplying what the client may view as “endless details,” a statutory pet trust provides a quick, economical, and easy method to carry out the pet owner’s intent. This assumes, of course, that the client establishes the trust in one of the jurisdictions that has enacted statutory pet trust legislation.

III. \textbf{INCOME TAXATION OF PET TRUSTS}

Pet trusts face income tax implications—at the federal and possibly state levels.\textsuperscript{39} The income of a trust is potentially taxed to one or more of the following entities: (1) the settlor (typically the pet owner), if the trust is inter vivos, (2) the beneficiary (typically the pet’s caregiver), or (3) the trust as a taxable entity itself.\textsuperscript{40}

\begin{flushleft}
\textsuperscript{38} See infra Part III.
\textsuperscript{39} See I.R.C. § 641 (2006); infra Part V.B.
\end{flushleft}
A. Federal Income Tax

After the settlor places property into a pet trust, the trustee has the duty to make the property productive which normally means to earn income or to appreciate in value (capital gains) or both.\(^41\) When that income is received or accrues, we must determine the entity responsible for the federal income tax on that income. Until 1976, the answer to the question of whether to tax pet trust distributions was simple; pet trust distributions were not taxed.\(^42\) The case of *In re Seabright* illustrated this point: to be taxed, the beneficiary receiving property must be a person.\(^43\) Because a statutory pet trust’s beneficiary is a pet, and a pet is not a person, the money given to the pet could not be taxed.\(^44\) Because this income was not taxed, the “loophole” allowed individuals to give money to establish pet trusts without income tax consequences—a problem the IRS fixed in 1976.\(^45\)

Under Revenue Ruling 76-486, the IRS does not recognize a pet as a “person;” therefore, a pet cannot be taxed under the I.R.C.\(^46\) To prevent pet owners from leaving money to pets for tax avoidance purposes, the Ruling voided any traditional trust which named a pet as a beneficiary.\(^47\) The Ruling allows specific state legislation to enable a pet as a beneficiary which


\(^{43}\) *In re Seabright’s Estate*, 95 N.E.2d 779, 784 (Ohio Ct. App. 1950).

\(^{44}\) See *id*.


\(^{46}\) I.R.C. §§ 7701(a) and 643(c); see *In re Seabright’s*, 95 N.E.2d at 784 (holding that the $1,000 the decedent bequeathed to his dog could not be subjected to taxes because the property passes to an animal, not a person, and only persons, institutions or corporations can be taxed); Abert, *supra* note 42, at 20.

\(^{47}\) Rev. Rul. 76-486. A traditional trust must have a beneficiary person and a pet is not a person so a pet cannot be a beneficiary; without a beneficiary, no trust exists. *See* Restatement (Third) of Trusts § 43
the I.R.C. taxes at the rate of a married individual filing separately.\footnote{48} Without a state statute allowing pet trusts, the Ruling invalidates the attempted pet trust because beneficiaries are persons, a pet is not a “person,” and, therefore, a pet could not be a beneficiary.\footnote{49} A side effect of this ruling changed the traditional method of deducting distributions from the trusts’ income.

1. Taxable to Settlor\footnote{50}

Taxes on an inter vivos pet trust might be owed by the settlor. The federal income tax is based on an individual’s adjusted gross income derived from all sources generating a gain for the taxpayer.\footnote{51} If an individual acquires the income from the pet trust by means of a “gift, bequest, devise, or inheritance” then this amount is exempted from income taxes.\footnote{52} When the trust is created, the transfer to the trust is not counted as income for the trustee, beneficiary, or caregiver; rather, the grantor or settlor would pay any tax liability (gift tax if inter vivos or estate tax if testate).\footnote{53}

Income the trust property earns thereafter is subject to the federal income tax unless an

\footnote{48} Rev. Rul. 76-486.
\footnote{49} \textit{Id.} The effect of invalidating the trust is to pass to residuary legatee.
\footnote{50} Only if the trust is inter vivos could this situation occur. Otherwise, the estate would be responsible for estate taxes and not the deceased settlor.
\footnote{51} I.R.C. § 61.
\footnote{52} \textit{Id.} § 102 (“Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance . . . [s]ubsection (a) shall not exclude from gross income . . . (2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.”).
exclusion or deduction applies.\textsuperscript{54} The trustee files a Form 1041 “Income Tax Return for Trusts and Estates” if the trust’s gross income is greater than $600.\textsuperscript{55} Income is realized only when the “funds earn interest or dividends within the trust, whether this income is accumulated or distributed.”\textsuperscript{56} Because income tax is triggered by the income earned off the corpus of the trust, it does not matter whether the trustee distributes the money.\textsuperscript{57} Thus, the federal income taxation of revocable inter vivos pet trusts should operate under traditional trust income taxation laws, which are beyond the scope of this article.\textsuperscript{58}

2. \textit{Taxable to Beneficiary}

If a statutory or traditional pet trust is created that names a human beneficiary, then the beneficiary would pay income taxes on gains distributed.\textsuperscript{59} The individual beneficiary and the pet’s caregiver are usually the same person.\textsuperscript{60} For example, the beneficiary could be the pet owner’s child who will also take care of the pet.\textsuperscript{61} But the beneficiary and the caregiver do not have to be the same person.\textsuperscript{62} If the caregiver is not the beneficiary, the animal’s caregiver serves merely as an agent for the trust, and the only taxable income for the caregiver is on amounts paid for services under normal tax rules, like any other income, and the beneficiary pays

\textsuperscript{54} I.R.C. § 641(a) (“Application of tax – The tax imposed by section 1(e) shall apply to the taxable income of estates or of any kind of property held in trust . . . when the caretaking funds earn interest or dividends within the trust, whether this income is accumulated or distributed.”).

\textsuperscript{55} See 1041 Instructions, supra note 40 at 3.

\textsuperscript{56} I.R.C. § 641.

\textsuperscript{57} Id.

\textsuperscript{58} See generally 42 Am. Jur. 2d Inheritance, Estate, and Gift Taxes §§ 71-93 (West 2008).

\textsuperscript{59} I.R.C. § 641.


\textsuperscript{61} Id.

\textsuperscript{62} Beyer Pet Animals, supra note 8, at 664-68.
income tax on trust distributions received. On the other hand, if the caregiver of the pet is also the beneficiary, then the caregiver reports all distributed income from the trust as personal income. Whether the trust itself is taxed on the distributions made depends on the classification of the trust itself. If distributions are made in either of these first two situations—settlor or beneficiary—these individuals pay the federal income tax on this income, if required, and the trust takes a deduction. If income is earned that is not distributed, then the trust pays taxes at the trust rates, and the trust also pays the tax when a non-human (i.e. pet) is the beneficiary, as would be the case in a statutory pet trust.

3. Taxable to Trust

The amount taxed to a pet trust and the tax rate for each of the three types of pet trusts might be different. The tax rate for a traditional pet trust on earned income is taxed at the normal trust rate under section 1(e) of the I.R.C. Under Ruling 76-486, a statutory trust is taxed at the same rate as a married individual filing separately under section 1(d) of the I.R.C. Both of these pet trusts would have a beneficiary appointed by the settlor-pet-owner or by the court in states adopting the UTC. In states where a pet trust becomes an honorary statutory trust, the special statutory-tax-rate status does not apply, even though this is a type of a statutory pet trust.

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63 Id. If the caregiver is reimbursed for the pet’s expenses or is paid a fee for his or her time, the caregiver would most likely be subject to income tax on this income. Id.; see discussion infra Part III.

64 I.R.C. § 661.

65 Id. Trusts are allowed to deduct the “distributable net income” paid to the caregiver/beneficiary or settlor as these individuals are people. Id.

66 Id.

67 See infra Part III.3.

68 I.R.C. §§ 1 and 641(a).


because the honorary statutory pet trust is an invalid one for I.R.C. purposes (though the court treats the trust as valid).\textsuperscript{71} The result is that an honorary statutory trust is taxed at the same rate as a traditional trust under section 1(e) of the I.R.C. and operates without a beneficiary for income tax deduction purposes.\textsuperscript{72} Therefore, the income tax on an honorary and traditional pet trust could be significantly higher than the income tax on a statutory pet trust because the income tax rate for a trust, as of 2008, is 35% on income over $10,700 compared with a 35% tax on income over $178,850 for a married individual filing separately.\textsuperscript{73}

Trusts are normally permitted to deduct distributions to beneficiaries from their income to arrive at its taxable income.\textsuperscript{74} The effect of Ruling 76-486 also changed the simple pet distribution procedure—now, pet trust distributions might be taxed and might not be taxed depending on whether the beneficiary is a human or a pet (and this resulting change could affect the income taxes of the pet trust and/or the beneficiary).\textsuperscript{75} Because pets are not people, however, a statutory pet trust is liable for the income a trust earns, but not credited for distributions made to the pet beneficiary.\textsuperscript{76} Thus, a statutory pet trust’s income is not reduced by distributions made on behalf of the pet and all income, whether distributed or not, must be taxed at the rate as a

\textsuperscript{71} See Rev. Rul. 76-486.
\textsuperscript{72} \textit{Id.}; see I.R.C. § 1 (amended tables).
\textsuperscript{73} I.R.C. § 1. Because most pet trusts are not likely to produce $125,000 in income, examining the first step of the rate schedule is even more helpful. \textit{See id.} Once a trust produces income over $1,500 the rate jumps every additional $2,000 in income from 15% to 28% then 31% and 36% before topping out at 39.6% at just $7,500 in income compared to the rate for married individuals filing separately which allows for the statutory pet trust to realize income up to $18,450 at just a 15% tax rate. \textit{See id.} This analysis does not take into account the special exception for the traditional trust which distributes to a human beneficiary as discussed below. \textit{See discussion infra} Part III.2.
\textsuperscript{74} I.R.C. § 641.
\textsuperscript{75} \textit{Id.} Trusts are permitted to deduct distributions to beneficiaries from their income to arrive at taxable income. \textit{Id.}; see 1041 Instructions, \textit{supra} note 40, at 2.
\textsuperscript{76} Rev. Rul. 76-486.
married individual filing separately. The IRS’s reasoning is logical since animals do not have a Social Security number that would allow them to file tax returns and have their own tax rates. But the ruling does add another tax implication for the practitioner trying to decide between a statutory pet trust and a traditional pet trust. Traditional trusts with a person beneficiary, however, still enjoy distributions as deductible expenses to the trust’s income. A traditional trust benefits from the distributions made to the beneficiary because each distribution decreases the pet trust’s tax liability. What federal income tax advantages and disadvantages now exist for the thoughtful pet owner?

4. Does the Type of Pet Trust Present Tax Advantages for AJ and Pat?

The following table summarizes the basic rules discussed above.

Table 1:

<table>
<thead>
<tr>
<th>Type of Trust</th>
<th>Tax Bracket</th>
<th>Distributions</th>
<th>Person/Entity Taxed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional</td>
<td>I.R.C. § 1(e): Trust Rate</td>
<td>- Deductible to the Trust - Taxable as Income to Human Beneficiary-Caregiver or Settlor</td>
<td>Gains Not Distributed: Trust Gains Distributed: Settlor or Human Beneficiary</td>
</tr>
</tbody>
</table>

77 Id. (“Furthermore, since the amounts of income required to be distributed under section 651 of the Code and amounts properly paid, credited, or required to be distributed under section 661 are limited to distributions intended for beneficiaries, a deduction under those sections is not available for distributions for the benefit of a pet animal. Similarly, such distributions are not taxed to anyone under sections 652 and 662”); see I.R.C. §§ 643(c), 652, and 7701(a); Abert, supra note 42, at 20.

78 Abert, supra note 42, at 20 (“Although some authorities are now recommending that pets have their owners’ Social Security numbers tattooed on their thighs, see USDA Animal and Plant Health Inspection Service Factsheet, "Safeguarding Pets," September, 1997, available from APHIS, USDA, 4700 River Road, Unit 84, Riverdale, MD 20737, this author has not discovered any proposal that animals should have their own tax identification numbers.”).

79 See 1041 Instructions, supra note 40, at 2.

80 I.R.C. § 641. Trusts are permitted to deduct distributions to beneficiaries from their income to arrive at taxable income. Id.
Because the trust’s tax rate and deductibility of distributions are different among the three pet trusts, the amount of federal income tax each trust will be liable for varies greatly. Similarly, the type of trust used will determine how much tax, if any, is owed by the beneficiaries (human or non-human). Pet owners should be careful that their state recognizes statutory pet trust because from an income tax standpoint, the honorary trust enjoys neither the lower tax rate for statutory pet trusts under section 1(d) of the I.R.C nor the ability to deduct distributed income from the high income trust tax rate as a traditional trust can under sections 1(e) and 651 of the I.R.C. Thus, the honorary trust will not be analyzed below because the tax owed would be the highest amount under the statutory trust scenarios for the human beneficiary added to the highest amount under the traditional trust scenarios for the individual trust. However, something might be better than nothing, and the court’s interpreting and carrying out the pet owner’s intention instead of voiding the trust might save the pet’s future existence.

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81 Rev. Rul. 76-486 (“Furthermore, since the amounts of income required to be distributed under section 651 of the Code and amounts properly paid, credited, or required to be distributed under section 661 are limited to distributions intended for beneficiaries, a deduction under those sections is not available for distributions for the benefit of a pet animal. Similarly, such distributions are not taxed to anyone under sections 652 and 662”). Some, however, might argue that the distributions would be taxable as income but Revenue Ruling 76-486 states otherwise.

82 I.R.C. §§ 1, 643(c), 651, and 7701(a); Rev. Rul. 76-486.

83 See supra notes 34-38 and accompanying text.
Application of the federal income tax law to traditional and statutory trusts creates income tax advantages and disadvantages which the AJ and Pat hypotheticals will demonstrate for beneficiaries and for the trust. Note that the potential taxes the settlor may owe are covered in Part IV.

Scenario 1a—AJ’s Traditional Trust with a Human Beneficiary

AJ wants to provide for Max and Charlie so AJ creates a $1 million Traditional Pet Trust in an account earning 5% annually and names Anne as the beneficiary and caregiver of Max and Charlie. In the first year after AJ’s death, the trust earned $50,000 ($1 million principal X 5% interest). Assume pet expenses totaling $25,000 and $25,000 as Anne’s stipend.

Under Scenario 1a, the $50,000 distribution is deducted from the trust’s income. Thus, the income of the trust is zero in Year 1, and the trust’s income tax is zero. The distributions to Anne count towards her income so the trustee files a Form 1041 Schedule K-1. Assume that Anne’s income for tax bracket purposes is $78,850 before the distribution and is unmarried. The following chart shows the income tax:

<table>
<thead>
<tr>
<th>Tax Bracket: Anne</th>
<th>Single Individual Filing</th>
</tr>
</thead>
</table>

84 For simplicity, the calculations do not take into account all I.R.C. sections.
85 I.R.C. § 661.
86 Id.
87 See 1041 Instructions, supra note 40 at 3.
Thus, under the traditional trust, the federal income tax owed is as follows:

1) Income Tax Liability for Beneficiary Anne on the Distribution: $14,000

2) Income Tax Liability of the Pet Trust: $0

The tax advantage of having a person and not the pet as a beneficiary with a traditional trust is the possibility of the trust distributing all gains to pay income tax at an individual’s presumably lower rate as compared to the trust owing taxes at the higher trust tax rate. One disadvantage for Anne, as the beneficiary, is using more than half of her stipend (trust distribution) to cover the income tax on the distribution. Pet owners should factor how much the caregiver’s actual salary needs to be for payment of services plus reimbursement of pet expenses and adjust accordingly for income taxes on the distributed amount with enough remaining for pet expenses. If a pet trust reimburses for only pet expenses and the caregiver performs the services for no salary, these distributions are still taxable, and, thus, the trustee should be instructed to distribute to pay these expenses plus an amount equal to the amount of anticipated taxes caused by the expense reimbursement. Also, this scenario assumes the total amount earned is distributed. If, however, a different situation exists and only $10,000 is distributed, the remaining $40,000 taxed at the trust rate of 35% creates a tax bill of $14,000 for the trust and Anne would owe $2,800 in taxes on the distribution for a total tax bill of $16,800. Thus, the lower the income bracket of the beneficiary and the more income that is distributed, the lower the total tax liability.

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89 See I.R.C. § 661.
is for both the trust and the human beneficiary.

**Scenario 1b—Pat’s Traditional Trust with a Human Beneficiary**

Pat wants to provide for Socks so Pat creates a $10,000 Traditional Pet Trust in an account earning 5% annually and names Ben as the beneficiary and caregiver of Socks. In the first year after Pat’s death, the trust earned $500 ($10,000 principal X 5% interest). Assume pet expenses totaling $300 and $200 as Ben’s stipend to cover taxes.

Under Scenario 1b, the $500 distribution is deducted from the trust’s income. The income of the trust is $0 in Year 1, and the trust’s income tax is $0. Assume that Ben’s income for tax bracket purposes is $32,550 before the distribution and is unmarried. The following chart shows the income tax:

<table>
<thead>
<tr>
<th>Tax Bracket: Ben</th>
<th>Single Individual Filing</th>
</tr>
</thead>
<tbody>
<tr>
<td>15%</td>
<td>$4,481.25 in taxes on his $32,550 in income +</td>
</tr>
<tr>
<td>25%</td>
<td>$125 in taxes on the pet trust distribution = $4,606.25 total taxes</td>
</tr>
</tbody>
</table>

Thus, under the traditional trust, the federal income tax owed is as follows:

1) Income Tax Liability for **Beneficiary** Ben on the Distribution: $125

2) Income Tax Liability of the Pet **Trust**: $0

Both scenarios 1a and 1b deal with traditional amounts but present different amounts so the

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90 I.R.C. § 661.

91 Id.

92 See id. § 1 and 2008 Tax Rate Amendments.
comparison between traditional and statutory trusts for different socioeconomic pet owners is more easily distinguishable when all the scenarios are compared together.  

Scenarios 2a-2f: Statutory Trusts

Now the Scenario changes to reflect a “valid” statutory pet trust. Some uncertainty in the tax treatment for these types of trust exists, which the IRS has not cleared up. First, one possible treatment is that income earned and not distributed by the trust is taxed at the special rate under Section 1(d) and amounts distributed to the caregiver are deducted as in a traditional trust and taxed as income of that person. Scenarios 2a and 2b show how this analysis would work.

The second option is that all the income earned by the statutory trust would be taxed under Section 1(d) and amounts distributed to the caregiver would not be deductible under Section 641 (because the caregiver is not the beneficiary) but the caregiver would still be taxed for this “income.” This tax treatment would create sever tax disadvantages and setbacks to statutory pet trusts as illustrated in Scenarios 2c and 2d and this interpretation is not supported by the language of Revenue Ruling 76-486.  

The final option might be that all income earned by the statutory trust is taxed at the Section 1(d) rate and the distributions, while technically are sent to the caregiver because Max is unable to deposit funds, is not treated as income for the caregiver, who is merely acting as an agent, but income of the pets, and pets do not pay income taxes. The advantage for the statutory pet trust over other trusts is that regardless of whether the income is distributed or not, the

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93 See infra “Summary of Scenarios” notes 108-114 and accompanying text.

94 Rev. Rul. 76-486, 1976-2 C.B. 192 (“Furthermore, since the amounts of income required to be distributed under section 651 of the Code and amounts properly paid, credited, or required to be distributed under section 661 are limited to distributions intended for beneficiaries, a deduction under those sections is not available for distributions for the benefit of a pet animal. Similarly, such distributions are not taxed to anyone under sections 652 and 662”).
income tax liability remains the same. This might be a helpful consideration to the pet owner because the incentive to distribute all income to avoid the higher trust tax rate does not exist, unlike the situation for traditional pet trusts. Scenarios 2e and 2f illustrate this outcome.

Of importance is the Revenue Rulings’ focus on the importance of having a person to assign taxes to but not penalizing statutory trusts. Presumably, the first and third options are more likely to be the correct analysis but without guidance from the IRS or courts on this matter, the result is not definite.

Scenario 2a—AJ’s Statutory Trust with a non-human Beneficiary and a human caregiver

As a resident of State A, AJ writes, “I leave in trust upon my death $1 million to provide for Max and Charlie and designate Anne as the caregiver.” In the first year after AJ’s death, the trust earned $50,000 ($1 million principal X 5% interest). Assume pet expenses totaling $25,000 and $25,000 as Anne’s stipend.

Because Max and Charlie are non-human beneficiaries, the $25,000 in distributions would not be deducted from the trust’s income for Year 1 because pets are not persons.\(^{95}\) So the income of the trust in Year 1 in this Scenario is $50,000 minus the $25,000 distribution to Anne (a person) for a total of $25,000.\(^{96}\)

<table>
<thead>
<tr>
<th>Tax Bracket: Statutory Pet Trust</th>
<th>Married Individual Filing Separately</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% of $8,025</td>
<td>$802.50 +</td>
</tr>
<tr>
<td>15% over $8,025 but not over $32,550</td>
<td>$16,975 \times .15 = $2,546.25 + 802.50 = $3,348.75 tax</td>
</tr>
</tbody>
</table>


\(^{96}\) Id.; see I.R.C. § 1.
Thus, under the statutory trust, the federal income tax owed is as follows:

1) Income Tax Liability for Caregiver Anne’s Stipend: $7,000

2) Income Tax Liability of the Pet Trust: $3,348.75

3) Income Tax Liability for Beneficiaries Max and Charlie: $0

This $50,000 incurs a total income tax liability of $10,348.75. In this situation, a tax advantage exists because of Anne’s lower income. The more money that remains taxed at the statutory pet trust rate, the lower the tax liability because of the lower tax bracket. Also, this scenario plays out more favorably than under the traditional pet trust analysis in Scenario 1a because the statutory pet trust enjoys a lower rate than the trust rate under the traditional trust or Anne’s rate because of her other income.

Scenario 2b—Pat’s Statutory Trust with a non-human Beneficiary and a human caregiver

As a resident of State A, Pat writes, “I bequest in trust upon my death $10,000 to Socks and assign Ben as the caregiver.” In the first year after Pat’s death, the trust earned $500 ($10,000 principal X 5% interest). Assume pet expenses totaling $300 and $200 as Ben’s stipend.

Because Socks is a non-human beneficiary, the $300 in distributions would not be
deducted from the trust’s income for Year 1. So the income of the trust in Year 1 in this Scenario is $500 minus the $200 distribution to Ben (a person) for a total of $300.

<table>
<thead>
<tr>
<th>Tax Bracket: Statutory Pet Trust</th>
<th>Married Individual Filing Separately</th>
</tr>
</thead>
<tbody>
<tr>
<td>10% of $300</td>
<td>$30 in taxes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Tax Bracket: Ben</th>
<th>Single Individual Filing</th>
</tr>
</thead>
<tbody>
<tr>
<td>25% on the $200</td>
<td>$50 in taxes</td>
</tr>
</tbody>
</table>

Thus, under the statutory trust, the federal income tax owed is as follows:

1) Income Tax Liability for Caregiver Ben’s Stipend: $50

2) Income Tax Liability of the Pet Trust: $30

3) Income Tax Liability for Beneficiary Socks: $0

This $500 incurs a total income tax liability of $80. Again, a tax advantage exists because of Ben’s income decreasing the total amount of tax from $125 in Scenario 1b to $80.

**Scenario 2c—AJ’s Statutory Trust with a non-human Beneficiary and a human caregiver**

The facts remain the same as in scenario 2a.

First, the trust income of $50,000 would be taxed at the Section 1(d) rate. Next, Anne’s $25,000 distribution would be taxed at her individual tax bracket.

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97 Rev. Rul. 76-486.
98 Id.; see I.R.C. § 1.
99 Rev. Rul. 76-486.
100 Id.; see I.R.C. § 1.
Thus, under the statutory trust, the federal income tax owed is as follows:

1) Income Tax Liability for Caregiver Anne’s Stipend: $7,000

2) Income Tax Liability of the Pet Trust: $8,843.75

3) Income Tax Liability for Beneficiaries Max and Charlie: $0

This $50,000 incurs a total income tax liability of $15,843.75. This amount is significantly higher than Scenario 2a but only slightly than the traditional pet trust in Scenario 1a.

**Scenario 2d—Pat’s Statutory Trust with a non-human Beneficiary and a human caregiver**

The Facts remain the same as in Scenario 2b.

Because Socks is a non-human beneficiary, the $300 in distributions would not be deducted from the trust’s income for Year 1.\(^{101}\) The trust income of $500 is taxed at the Section 101

\(^{101}\) Rev. Rul. 76-486.
Next, Ben’s $200 distribution is taxed at his individual tax bracket.\textsuperscript{103}

\begin{center}
\begin{tabular}{|l|l|}
\hline
\textbf{Tax Bracket: Statutory Pet Trust} & \textbf{Married Individual Filing Separately} \\
\hline
10\% of $500 & $50 in taxes \\
\hline
\end{tabular}
\end{center}

\begin{center}
\begin{tabular}{|l|l|}
\hline
\textbf{Tax Bracket: Ben} & \textbf{Single Individual Filing} \\
\hline
25\% on the $200 & $50 in taxes \\
\hline
\end{tabular}
\end{center}

Thus, under the statutory trust, the federal income tax owed is as follows:

1) Income Tax Liability for Caregiver Ben’s Stipend: $50

2) Income Tax Liability of the Pet Trust: $50

3) Income Tax Liability for Beneficiary Socks: $0

This $500 incurs a total income tax liability of $100. Again, a tax advantage exists because of Ben’s income decreasing the total amount of tax from $125 in Scenario 1b to $100.

\textit{Scenario 2e—AJ’s Statutory Trust with a non-human Beneficiary and a human caregiver}

The Facts remain the same.

Under this last possibility, the trust income of $50,000 would be taxed at the Section 1(d) rate.\textsuperscript{104} Anne’s $25,000 distribution would not be taxed at her individual tax bracket because “. . . such distributions are not taxed to anyone under sections 652 and 662.”\textsuperscript{105}

\textsuperscript{102} See id.

\textsuperscript{103} See I.R.C. § 1.

\textsuperscript{104} Rev. Rul. 76-486.

\textsuperscript{105} Rev. Rul. 76-486.
### Tax Bracket: Statutory Pet Trust | Married Individual Filing Separately
---|---
10% of $8,025 | $802.50
15% of $32,550 | $3,678.75 + $802.50 = $4,481.25 +
25% over $32,550 but not over $65,725 | $17,450 X 0.25 = $4,362.50 + $4,481.25 = $8,843.75 tax

Thus, under this scenario, the federal income tax owed is as follows:

1) Income Tax Liability for Caregiver Anne’s Stipend: $0

2) Income Tax Liability of the Pet Trust: $8,843.75

3) Income Tax Liability for Beneficiaries Max and Charlie: $0

This $50,000 incurs a total income tax liability of $8,843.75. This amount is the lowest of the AJ’s scenario’s but probably not likely to be the analysis used by the IRS because any money received for taking care of the pets is most likely income of Anne and, as such, taxed to her individually but the distribution could be viewed as pet Max’s and Charlie’s income.\(^{106}\)

**Scenario 2f—Pat’s Statutory Trust with a non-human Beneficiary and a human caregiver**

The Facts remain the same.

The trust income of $500 is taxed at the Section 1(d) rate.\(^ {107}\) Ben’s $200 distribution is not taxed at his individual tax bracket if viewed as income of pet Socks.

### Tax Bracket: Statutory Pet Trust | Married Individual Filing Separately
---|---

\(^{106}\) See generally Abert, supra note 8.

Thus, the federal income tax owed is as follows:

1) Income Tax Liability for Caregiver Ben’s Stipend: $0

2) Income Tax Liability of the Pet Trust: $50

3) Income Tax Liability for Beneficiary Socks: $0

This $500 incurs a total income tax liability of $50.

Summary of the Scenarios

<table>
<thead>
<tr>
<th>Type of Trust</th>
<th>Total Tax Beneficiary or Caregiver or Beneficiary-Caregiver Anne or Ben Owes</th>
<th>Total Tax Trust Owes</th>
<th>Total Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>AJ’s Traditional 1a</td>
<td>$14,000</td>
<td>$0</td>
<td>$14,000</td>
</tr>
<tr>
<td>AJ’s Traditional 1c</td>
<td>$2,800</td>
<td>$14,000</td>
<td>$16,800</td>
</tr>
<tr>
<td>AJ’s Statutory 2a</td>
<td>$7,000</td>
<td>$3,348.75</td>
<td>$10,348.75</td>
</tr>
<tr>
<td>AJ’s Statutory 2c</td>
<td>$7,000</td>
<td>$8,843.75</td>
<td>$15,843.75</td>
</tr>
<tr>
<td>AJ’s Statutory 2e</td>
<td>$0</td>
<td>$8,843.75</td>
<td>$8,843.75</td>
</tr>
<tr>
<td>Pat’s Traditional 1b</td>
<td>$125</td>
<td>$0</td>
<td>$125</td>
</tr>
<tr>
<td>Pat’s Statutory 2b</td>
<td>$50</td>
<td>$30</td>
<td>$80</td>
</tr>
<tr>
<td>Pat’s Statutory 2d</td>
<td>$50</td>
<td>$50</td>
<td>$100</td>
</tr>
<tr>
<td>Pat’s Statutory 2f</td>
<td>$0</td>
<td>$50</td>
<td>$50</td>
</tr>
</tbody>
</table>

The statutory pet trust under Scenarios 2a, 2b, 2e and 2f have the best income tax advantage because of the different tax rates and tax brackets. In addition, the statutory pet trust
may not have the higher creation costs that may be associated the traditional trusts.\textsuperscript{108} Both types of trusts could have problems in distributing enough income to the caregiver to cover the pet’s expenses, pay for the caregiver’s time, and cover the income taxes (especially in situations where the caregiver is only being reimbursed for expenses and not making any money on caring for the pet).\textsuperscript{109} Moreover, even in the “worst” case tax treatment for the statutory pet trusts in Scenarios 2c and 2d, the total tax liability under the hypothetical earnings and distribution amounts is still lower than the amount of tax owed under traditional pet trusts Scenarios 1a or 1b.\textsuperscript{110} Regardless of whether a traditional or statutory pet trust is used, from an income tax perspective, the real “dog” is the honorary pet trust because of the high amount owed in taxes both by the trust on all income earned and by the beneficiary because the IRS does not recognize the honorary trust absent state legislation.\textsuperscript{111} Thus, from an income tax perspective, the pet owner should probably consider using a statutory pet trust in states where statutory pet trusts are authorized and a traditional trust in states without pet trust legislation for income tax savings.

5. \textit{Alternative Investment Strategies}

For all three pet trusts, the trustee should also consider clever investing in instruments such as tax-free municipal bonds.\textsuperscript{112} This option could be a tremendous way of reducing income tax liability for a trust in situations when the trust distributes to pay for pet reimbursement expenses. If, however, the money is intended as the caregiver’s salary, the caregiver will still


\textsuperscript{109} See \textit{supra} Scenarios.

\textsuperscript{110} See \textit{supra} Scenarios.

\textsuperscript{111} See \textit{supra} notes 82-83 and accompanying text.

\textsuperscript{112} I.R.C. § 75 (2006). If a trust is invested in tax free municipal bonds, than the income earned would be treated as tax free income earned in other trusts and not subjected to income tax.
owe income taxes but the trust would not. In addition, another option is for the assets to be invested for growth instead of income; however, income tax would incur when distributions are made. But the practicality of investing in either tax-free municipal bonds or growth instead of income might not make this option less feasible upon a closer look. The fact that Leona Helmsley makes the headlines with her $12 million pet trust shows how rare this type of gift is. More likely, most pet owners will leave a few thousand, as Pat did, and the choices will be much simpler. Therefore, from a federal income tax standpoint, because of the lower creation costs, administration and tax rates for statutory pet trusts, most pet owners will have a tax incentive to use statutory trusts over the traditional pet trust model.

**B. State Income Tax**

Forty-one states and the District of Columbia tax personal income under varying rules, exemptions, and rates. For example, California’s income tax starts at a flat rate of 1% of

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113 Abert, supra note 8, at 20.


personal income plus 2% - 9.3% additional income tax depending on one’s tax bracket which would affect the traditional trust’s beneficiaries.\textsuperscript{116} Similar to California, New York also has a state income tax for personal income and a state income tax for the income earned in a trust.\textsuperscript{117} State income taxes on trusts would add additional tax liability to the beneficiary pet or the beneficiary individual and, generally, would complement the analysis provided in the Scenarios for federal income tax of trusts provided in Part III, § A.\textsuperscript{118}

Texas, Wyoming, Washington, Nevada, Florida, and Alaska do not have state income tax on personal income.\textsuperscript{119} In addition, states such as New Hampshire, South Dakota, and

\textsuperscript{116} See CAL. PROB. CODE § 17041 (2008).

\textsuperscript{117} See N.Y. TAX LAW §§ 601, 290 (2008). Other states have equally interesting applicable statutes but this comment focuses on California, Texas, New York and Florida due to the high number of retirees present, many pet owners, who will soon trigger the situations discussed in this article.

\textsuperscript{118} See discussion supra Part III.A.

\textsuperscript{119} See Retirement Living Information Center, [hereinafter Retirement Living] Taxes By State, http://www.retirementliving.com/RLtaxes.html (last visited Sept. 28, 2008); BARBARA WELTMAN, 2007 STATE TAX HANDBOOK (CCH, Inc. 2007). Florida has some of the highest categories of retired people, which is a great tax advantage for setting up pet trusts for residents of these states because under section 220.03 and 220.11 of the Florida Code, only corporations, including common-law declarations of trust, are taxed at a basic rate of 5.5% of net income depending on the application of the federal alternative but no personal income tax exists. See FLA. STAT. ANN. §§ 220.03, 220.11 (West 2008); Florida Department
Tennessee, which do not have a personal income tax or limit the personal income tax to very specific situations (taxation of corporate interests), do impose a tax on the payment of certain dividends or interest earned by a trust that could add additional tax liability.\textsuperscript{120} Thus, pet trusts will have income tax ramifications in a majority of states.

\section*{IV. Gift Taxation of Pet Trusts}

The creation of an inter vivos pet trust may subject the pet owner (the donor) to gift tax at both the federal and state level. However, as this section explains, the average pet owner will probably not be effected by federal or state gift taxes because unlike the federal income tax which affects pet trusts after only one dollar in income is produced.

\subsection*{A. Federal Gift Tax}

If the donor does not retain the ability to revoke the pet trust created during the donor’s lifetime, the money or property used to fund the trust is a gift that is “transferred”\textsuperscript{121} and thus potentially subject to Federal gift tax.\textsuperscript{122} A gift is taxed based on its value—the amount a willing seller would take from a willing buyer—at the time of the gift.\textsuperscript{123} A pet trust established inter

\begin{flushleft}
\textsuperscript{121} I.R.C. § 2501(a).
\textsuperscript{122} Id. § 2001. Section 2001(c) defines the rate schedule with the first level of the gift at $10,000 or under computed at 18\% percent. The graduated rate increases up to the maximum level of any excess over $2,500,000 is taxed at 50\%. Id.
\textsuperscript{123} See Treas. Reg. § 25.2512-1 (as amended 1992); see also I.R.C. § 2512(a).
\end{flushleft}
vivos triggers a gift tax for the pet owner. 124 “Taxable gifts” is defined in the I.R.C. as the “total amount of gifts made during the calendar year,” minus the deductions provided for in §§ 2503 and 2522. 125 Gift taxes on donor’s taxable contributions to the trust might be eligible to offset with the gift tax credit which, as of 2008, is $345,800. 126 Because charitable remainders of pet trusts are not recognized by the IRS, it seems unlikely that a gifted pet trust would qualify for a charitable gift tax deduction if the remainder beneficiary of the trust is a charity.

Scenario 3:

Worried that a testamentary trust will lock up necessary funds for Max and Charlie, AJ sets up an inter vivos pet trust. In 2008, AJ creates a trust, assigns Max and Charlie as the beneficiary, and transfers the $1 million without keeping control. At the end of 2008, assuming AJ has made no other taxable gifts in 2008, AJ’s federal gift tax liability would be $345,800. 127 If AJ has not make taxable gifts in prior years, no tax would be owed on the transfer. Based on caselaw and statutory research and the lack of clear guidelines for gift tax purposes, it does not seem to matter whether a traditional, statutory, or honorary pet trust is used, rather whichever trust is picked affect income and estate tax planning. 128

B. State Gift Tax

Only the states of Connecticut, Louisiana, North Carolina, and Tennessee impose a state gift tax. 129 In Connecticut, the gift tax is imposed on residents or nonresidents on a rate table

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124 I.R.C. § 2501.
125 Id. § 2503(a).
126 Id. §§ 2505 and 2012.
127 I.R.C. §§ 2001(c)(1) and 2010.
128 See discussion supra Part III.
from 1% up to 6%.\textsuperscript{130} Louisiana’s and North Carolina’s gift tax threshold is $12,000.\textsuperscript{131} Tennessee’s gift tax threshold is based on the relationship between donor and recipient.\textsuperscript{132} Louisiana’s gift tax rate is 2% for gifts up to $15,000 in value and 3% for gift amounts over $15,000.\textsuperscript{133} The gift tax exclusion is tied to the federal gift tax exclusion and is indexed for inflation in both Louisiana and North Carolina.\textsuperscript{134} The maximum lifetime exclusion allowed by Louisiana is $30,000, while the lifetime amount for certain recipients may be as high as $100,000 in North Carolina.\textsuperscript{135} North Carolina categorizes gift recipients based on their relationship with the donor.\textsuperscript{136} Lineal descendants and ancestors make up Class A while the more distant relatives (aunts, uncles) are assigned to Class B.\textsuperscript{137} Class C encompasses all other gift recipients.\textsuperscript{138} North Carolina’s gift tax rates are also pegged to these three Class categories and the tax rate ranges from 1% to 12%.\textsuperscript{139} Tennessee’s gift tax statutes create two categories of Classes—Class A for family members (spouse, children, lineal relations, etc) and Class B for everyone not included in Class A.\textsuperscript{140} A gift between spouses might exclude up to 50% of the

\textsuperscript{130} See §§ 12-340-43 (stating the tax on transfers of property) and Chapter 228c (§§ 12-640-49) (2000) (imposing gift taxes).

\textsuperscript{131} LA. REV. STAT. ANN. § 47:1205 (2008); N.C. GEN. STAT. ANN. § 105-188(d) (West 2008).

\textsuperscript{132} TENN. CODE ANN. § 67-8-104 (West 2008).

\textsuperscript{133} See LA. REV. STAT. ANN. § 47:1206 (2008).

\textsuperscript{134} See LA. REV. STAT. ANN. § 47:1205 (2008); N.C. GEN. STAT. ANN. § 105-188 (West 2008).

\textsuperscript{135} See LA. REV. STAT. ANN. § 47:1205(B) (2008); N.C. GEN. STAT. ANN. § 105-188 (West 2008).

\textsuperscript{136} N.C. GEN. STAT. ANN. § 105-188 (West 2008).

\textsuperscript{137} Id.

\textsuperscript{138} Id.

\textsuperscript{139} Id.

\textsuperscript{140} TENN. CODE ANN. § 67-8-102 (West 2008).
value while the annual gift tax exemption will change depending on Class A or Class B gift recipients.\footnote{141} Tennessee also has a gift tax range which spans from 5.5\% to 9.5\% for Class A and 6.5\% to 16\% for Class B.\footnote{142}

### V. ESTATE TAXATION OF PET TRUSTS

An estate tax is the tax on an individual’s privilege of transferring property upon death.\footnote{143} The creation of a testamentary pet trust may subject the pet owner’s estate to estate tax at both the federal and state level. As with the gift tax discussed above, however, the average pet owner will probably not be effected by federal or state estate taxes.

#### A. Federal Estate Tax

Because “[t]he value of the gross estate * * * includes the value of all property to the extent of the interest therein of the decedent at the time of his death,”\footnote{144} property which the pet owner leaves to a testamentary pet trust is potentially subject to the estate tax.\footnote{145} This is true even if the asset left behind is municipal bonds, which only escapes income tax, not estate transfer tax.\footnote{146} Non-probate assets used to fund the trust, such as a trust being named the beneficiary of the pet owner’s life insurance policy, retirement plan, annuity, etc. are outside the

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\footnote{141} See \textsc{Tenn. Code Ann.} § 67-8-105 (West 2008) (interspousal transfers); \textsc{Tenn. Code Ann.} § 67-8-104 (West 2008) (exemptions).
\footnote{142} \textsc{Tenn. Code Ann.} § 67-8-106 (West 2008).
\footnote{144} \textsc{I.R.C.} § 2033; see \textsc{I.R.C.} §§ 2010-16 (establishing the progressive estate tax rates); see also \textsc{I.R.C.} §§ 2031-46 (covering the ways to compute the value of an estate).
\footnote{145} \textit{Id.} § 2001 (“[a] tax is hereby imposed on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States”).
\footnote{146} See \textsc{Gerry Beyer, Wills, Trusts, and Estates: Examples and Explanations} 525 (3rd ed. 2005).
scenario of this article. Again, the type of trust does not seem to make a difference for these purposes.

Scenario 4:

AJ wants to provide for Max and Charlie so AJ creates a $1 million pet trust for their lifetime benefit and names Anne as the caregiver. As is common in pet trusts (including possibly Leona Helmsley’s trust for Trouble), petowner AJ names “We Help Pets,” an IRS-qualified charitable organization that assists animals, as the remainder beneficiary. After AJ’s death, the $1 million pet trust would be included in AJ’s estate, even if the trust qualified as a charitable remainder exception trust because of Revenue Ruling 78-105.

Most estates will not need to worry about the federal estate tax as the exemption for an estate is currently at $2,000,000 and will increase to $3,500,000 in 2009. However, if the estate is over the exemption amount, the tax rate can be as high as 45% in 2007, 2008 and 2009. So if AJ’s estate is valued over $2,000,000 when she creates a $1 million pet trust for Max and Charlie, then the tax bill could be as high as $450,000 on the $1 million trust. If she has a large estate or has not already exhausted her applicable credit amount, she might consider an inter-vivos pet trust. Under current rates, a $1 million gift incurs a tax liability of $345,800

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150 Id. § 2001.

151 Id. §§ 2001 and 2010 (computing $1,000,000 X .45 = $450,000).

152 I.R.C. §§ 2001(c)(1) and 2010.
under the federal gift tax statutes compared to a $450,000 tax liability under the current estate tax rate for a multi-million dollar estate.  

**B. State Estate Tax**

Unlike the rarity of a state gift tax, most states do have a type of state estate tax including California, Florida, New York, and Texas. A few states do not have a state estate tax. There are three common state estate taxes: (1) a pick-up tax, (2) estate tax on the ability or privilege to transfer property, and (3) estate tax on those inheriting property.

The pick-up tax, as applied to the federal estate tax credit or offset, should not increase an estate’s tax bill. A significant number of states have this type of state estate tax. Because the federal estate tax credits an estate for state taxes, if the state did not have this type of estate tax, the amount owed will be the same but the taxes would be paid entirely to the federal government instead of to the federal and state government. Because the amount of estate tax owed does not increase, there should be no effect on pet trusts under these types of state estate tax.

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153 See §§ 2001 and 2010-16.

154 As the four most populous states in the Union (California, Texas, New York, and Florida), these state’s estate and gift tax laws are examined with the assumption that many pet owners will be located in one of these three areas. See U.S. Census Bureau, National and State Population Estimates, available at http://www.census.gov/popest/states/NST-ann-est.html (last visited Oct. 22, 2007).

155 CAL. REV. & TAX. CODE §§ 13302-04 (West 2000); FLA. STAT. § 198.02-.44 (2005); and N.Y. TAX LAW §§ 952, 954, 957-58, 960-a, 961 (McKinney 2004); TEX. TAX CODE ANN. § 211.051 (Vernon 2002). However, because Texas has not “decoupled,” there is effectively no estate tax in Texas at the present.

156 See Retirement Living, supra note 120.

157 See generally WELTMAN, supra note 119.

158 See Retirement Living, supra note 120. However, the federal government now treats state death taxes as a deduction instead of a credit and many states, including Texas, have not “fixed” their tax law to provide for a substitute.

159 CAL. REV. & TAX. CODE §§ 13301-02 (West 2007) (imposing an estate tax on the amount applicable under federal estate tax law).

160 See generally WELTMAN, supra note 119.
The second type of state estate tax, the tax on transfer of property at death, is similar to the application of the federal estate tax discussed supra with state by state differences for exemptions and deductions. The pet owner’s estate would incur additional state tax liability for pet trusts created.

The third category, taxing the heir or beneficiary, operates much like a gift tax and the amount owed many times is determined by how closely related the heir is due to the exemptions and deductions provided by state law for family members. A few states have an inheritance tax. Using this state estate tax structure, pet trusts would also incur additional state tax liability.

If AJ or Pat are living in a state with the “pick-up” estate tax, they would not notice any additional tax burden. Under both the second and third categories, practitioners should research their state’s gift and estate tax law. If a state did not have a state gift tax statute (as most states do not), but had a state estate tax of the second or third category, the pet owner might reap tax savings by establishing an inter vivos pet trust that would not be subject to either the federal or state estate taxes. Under any of the three state estate taxes, pet owners should seek a local tax practitioner for planning advice and details about her state estate tax’s effect.

161 See Retirement Living, supra note 120.
162 See Retirement Living, supra note 120.
163 See generally WELTMAN, supra note 119.
164 See id.
165 See supra notes X-X and accompanying text.
166 See supra note 129 and accompanying text.
C. Charitable Remainder Exception

A charitable remainder is what passes to an IRS-authorize charitable organization after the trust’s original purposes ceases.\textsuperscript{167} Generally, a decedent’s estate may obtain an estate tax deduction for the value of a remainder interest passing to a charity if the requirements of a charitable remainder unitrust or charitable retained annuity trust are satisfied.\textsuperscript{168} A charitable retained annuity trust (CRAT) has several specific requirements.\textsuperscript{169} Amounts must be distributed on a scheduled and, at least, an annual basis with 5% or more of the trust’s corpus being distributed.\textsuperscript{170} The original amount of the trust is set from the beginning with no additional contributions.\textsuperscript{171} Moreover, when the trust terminates, 10% of the original value must have been preserved.\textsuperscript{172} If all these requirements are fulfilled, a deduction for the original amount invested is allowed.\textsuperscript{173}

With normal trusts, a deduction is given for testamentary gifts left to IRS-qualified charitable organizations.\textsuperscript{174} However, in Revenue Ruling 78-105, the IRS stated that it would not allow the amount passing to a pet trust for the lifetime benefit of a pet to qualify for charitable deduction given under the estate tax.\textsuperscript{175} This ruling even affects those pet trusts whose

\begin{itemize}
\item \textsuperscript{167} \textsc{Restatement (Third) Trusts} § 28 (2003); see I.R.C. § 664 (2006).
\item \textsuperscript{168} I.R.C. §§ 664 (describing charitable remainder trusts), 2055(a) (2006) (allowing charitable contributions to be deducted from estate), 2055(e)(2).
\item \textsuperscript{170} See id.
\item \textsuperscript{171} See id.
\item \textsuperscript{172} See id.
\item \textsuperscript{173} See id.
\item \textsuperscript{174} I.R.C. § 2055.
\item \textsuperscript{175} Rev. Rul. 78-105, 1978-1 C.B. 295.
\end{itemize}
remainder beneficiary is an IRS-qualified charity.\textsuperscript{176} The facts in the ruling indicated a decedent leaving a trust with trustee instructions to pay a certain monthly amount for pet expenses, and upon the pet’s death, for the trust to terminate and the remainder be paid to the charity designated.\textsuperscript{177} Three situations were considered based on these facts.\textsuperscript{178} The decedent in example 1 was a resident of a state which permitted a trust for a pet’s care.\textsuperscript{179} In example 2, the decedent resided in a state where a pet trust was valid but merely honorary because no statute existed that allowed a beneficiary to enforce the trust.\textsuperscript{180} In the third and final example, the decedent resided in a state in which a pet trust was void at its inception.\textsuperscript{181} The IRS held that no charitable deduction would be allowed in either example 1 or example 2.\textsuperscript{182} The IRS determined that a trust for the care of a pet does not fulfill Sections 664(d)(1) and 2055(e)(2) of the Internal Revenue Code.\textsuperscript{183} Interestingly, in example 3 for federal tax purposes, the pet trust did fulfill the requirements of the Internal Revenue Code because by being void from its inception, the remainder interest was accelerated and the present interest vested.\textsuperscript{184} Thus, the value of the interest passed directly to the charity at the time of the decedent’s death and would be allowed a charitable remainder exception deduction under Section 2055(a) of the Internal Revenue Code.\textsuperscript{185}

The charitable remainder exception should be a great tax planning tool for the pet

\textsuperscript{176} See id.  
\textsuperscript{177} See id.  
\textsuperscript{178} See id.  
\textsuperscript{179} Id.  
\textsuperscript{180} Id.  
\textsuperscript{181} Id.  
\textsuperscript{182} See id.  
\textsuperscript{183} See id.  
\textsuperscript{184} See id.  
\textsuperscript{185} See id.
owner—but it’s not. A pet owner establishing a pet trust whose remainder passes to a charitable organization cannot benefit from this federal law. Because the pet beneficiary is not a person, the IRS has stated that a pet trust’s remainder which transfers to a charitable beneficiary cannot benefit from the charitable remainder deduction. Payments must be made to a person, and a pet is not a “named person or persons” described in the regulations for purposes of Section 7701 of the Internal Revenue Code; thus, the pet trust is excluded from this beneficial deduction. Arguably, if a traditional trust that satisfies the CRAT rules is established with a human beneficiary and the trust is not for lifetime benefit of the pet, the charitable remainder exception might apply. The difficulty would be avoiding the IRS’s interpretation of “trust for the lifetime benefit of a pet” under Revenue Ruling 78-105, which appears to be a trust whose money is used for the care of a pet.

Example:

If AJ establishes a $1 million pet trust for Max and Charlie with the remainder passing to ABC Pet Sanctuary (an IRS recognized charitable organization), the trust is treated as a normal pet trust without any special tax deductions. Interestingly, enough, if AJ or Pat lives in a state that does not recognize pet trusts and the state declares the trust invalid, the invalidation causes the “remainder interest contribution to the charitable institution to be accelerated (by

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186 See infra notes 187-197 and accompanying text.
188 See id.
190 See Rev. Rul. 78-105.
191 I.R.C. § 501(c)(3) recognizes a pet sanctuary as charitable organization.
reason of failure of the trust[])” allowing the charitable reminder to exist and also allowing the entire amount as a deductible charitable contribution from the estate. In this situation, AJ’s failed attempt at creating a trust would enable her estate to claim the $1 million as a charitable deduction from estate taxes.

During the last decade, changes to this part of the estate law have been proposed by Representative Earl Blumenauer. These changes are known as the “Morgan Bill.” The Morgan Bill would allow an estate to deduct amounts transferred to a charitable remainder pet trust during the pet(s) lifetime with the remainder transferred to a recognized charitable organization. This proposal would amend the IRC to allow CRAT pet trusts to enjoy the charitable estate tax deduction of normal CRAT trusts. However, the bill has not been the subject of any debate or Congressional vote.

192 Rev. Rul. 78-105; see I.R.C. §§ 664 (describing charitable remainder trusts), 2055(a)-(e) (allowing charitable contributions to be deducted from estate), 7701; Treas. Reg. §§ 1.664-2(a)(3), 1.664-3(a)(3); see also Abert, supra note 8, at 22.


195 Abert, supra note 842, at 22; see H.R. 2491 § 1(c)(5).

196 See H.R. 2491 § 1(c)(5).

VI. RECOMMENDATIONS

A. For Practitioners

From a taxation standpoint, attorneys must decide first whether to create an inter vivos pet trust or a testamentary pet trust. Attorneys should consider the client’s total lifetime gifts under the federal gift statute and under any applicable state gift statutes for those living in the states of Connecticut, Louisiana, North Carolina, or Tennessee. If the client has a large estate, has not taken advantage of gift tax credits, or lives in a state with a harsh state estate tax, the inter vivos pet trust—traditional, honorary, or statutory—might save the owner’s estate a hefty estate tax liability on both a federal and state level. Just remember that the gift tax has a smaller exemption amount compared to the estate tax exemption amount. If the client has a small estate, has used her gift tax credit, or can save tax liability after consulting with federal and state estate tax statutes then a testamentary pet trust—traditional, honorary, or statutory—would be an appropriate, common choice. Additionally, if the pet were to die while the owner was still alive, arguably savings would exist on a testamentary trust that no longer needs to be established.

Practitioners can take several simple steps on behalf of their clients. See Beyer website, supra note 30, at 4-7 (showing detailed examples of formats for these documents). Pet owners should prepare and in some cases carry 1) an animal card, which contains the name, animal type, location, and special care instructions of the pet; 2) an animal document, which contains the information from the animal card and any additional details, that is stored with the estate documents; 3) a door sign to alert individuals of pets in the house; and 4) special instructions for the owner’s power of attorney that authorize the agent to care for the pet and amounts to spend. See id.

See supra Part IV. From a non-taxation standpoint, the owner should also consider that advantages for an inter vivos include the following: 1) the pet trust is effective immediately and already working at the pet owner’s death without waiting for probate courts; 2) funds are immediately available for pet care and needs; and 3) the trust can be nominally funded and an account created which names the trustee as the beneficiary to provide pet funds upon the owner’s death. See Beyer website, supra note 30, at 8.

See supra Parts IV-V.

See supra Parts IV-V.

See supra Parts IV-V.
versus an inter vivos trust established and running up administrative costs but no longer needed.\footnote{203 See Beyer website, supra note 30, at 8.}

Next, a practitioner should consider the income tax ramifications of the traditional versus the statutory pet trust and who is better suited to pay the taxes—the settlor, the beneficiary, or the trust? An honorary pet trust would only be established in the few remaining states that would otherwise invalid the pet trust.\footnote{204 See supra Part II.4.} Because these states would not recognize a statutory pet trust, an honorary pet trust or traditional trust with appropriate instructions is the practitioner’s only choice.\footnote{205 See supra notes 82-83 and accompanying text.} Even though honorary pet trusts will pay more in income taxes than the traditional and statutory pet trusts, the pet owner will probably be happy that any trust at all will be allowed to care for the beloved pet(s).\footnote{206 See supra notes 82-83 and accompanying text.}

The traditional pet trust is more common due to the increased pet owner’s control over the pet’s care, but the analysis performed in Part III shows that income accumulated in the trust is subject to the higher trust tax rate, even though the trust enjoys a deduction for distributions to the human beneficiary.\footnote{207 See Beyer website, supra note 30, at 8; supra Part III.A.4.} The fewer the distributions, the higher the tax liability owed by the trust with a traditional pet trust.\footnote{208 See supra notes 79-80 and accompanying text.} Moreover, if the traditional pet trust is established inter vivos, the settlor might have federal and state gift tax liability.\footnote{209 See supra Part IV.} If the traditional pet trust is testamentary in nature, the settlor’s estate must face federal and state estate tax liability.\footnote{210 See supra Part V.}
Finally, distributions to the human beneficiary under a traditional pet trust will incur tax liability for the beneficiary.\(^{211}\) Thus, a traditional pet trust can trigger many of the tax liabilities for one, two, or all three of the classes of people affected when a pet trust is created (settlor, beneficiary, trust).\(^{212}\) If a traditional pet trust will distribute each year most or all of the income earned by the trust (and maybe even some of the corpus of the trust) and the beneficiary is in a low income tax bracket, the traditional pet trust could enjoy income tax advantages over the statutory pet trust for both the beneficiary and the trust.\(^{213}\) Regardless, the settlor’s ability to enjoy tax advantages under a traditional pet trust will depend up the owner’s estate and gift tax credits or exemptions available.\(^{214}\)

On the other hand, if the corpus of the pet trust will be a large amount and the amounts distributed are kept to a lower rate, then the statutory pet trust enjoys tax savings for both the trust and the pet beneficiary.\(^{215}\) First, the advantage for the trust is that a lower tax rate (married individual filing separately versus high trust rate) is used and the income of this “taxpayer” (statutory pet trust) is the only income as compared to a human beneficiary of a traditional pet trust whose trust distributions would be stacked on top of presumably several thousand dollars in personal income.\(^{216}\) Second, the advantage for the pet beneficiary is that a pet cannot be taxed under statutory and case law.\(^{217}\) In essence, the income is possibly taxed to the settlor at time of

\(^{211}\) See supra Part III.A.2.

\(^{212}\) See supra Part III.A.

\(^{213}\) See supra Part III.A.4.

\(^{214}\) See supra Parts IV-V.

\(^{215}\) See infra notes 216-219 and accompanying text.

\(^{216}\) See supra Part III.A.4. This increased taxable income of the human beneficiary for the traditional pet trust would result in a higher tax rate and higher tax liability than under the statutory pet trust. See supra Part III.A.4.

\(^{217}\) See supra note 46 and accompanying text.
pet trust creation or the owner’s death and taxed to the trust when income is earned because distributions to pets are not deductible.\textsuperscript{218} Thus, the income should not incur tax liability at the beneficiary stage because the pet is not a human person.\textsuperscript{219}

A settlor can establish a statutory pet trust when the pet owner dies. Taxation advantages could exist for the settlor to establish inter vivos traditional pet trusts in states not recognizing pet trusts if he or she has a really large estate whose maximum tax rate would be higher than the gift tax rate. On the other hand, if a wealthy individual will not use all his or her exemption amounts because most of the assets are non-probate assets, a statutory pet trust might be a tax advantageous option. Additionally, the longer the pet trust will last (i.e. parrot or horse) the more likely the start up costs of a traditional inter vivos pet trust will be capitalized over the life time of the trust, especially if the income tax per year is less than a statutory pet trust.

\textbf{B. For Congress}

Congress should consider enacting the Morgan Bill.\textsuperscript{220} The estate tax deduction would benefit both pet owner’s estates (especially because the traditional pet trust is a common way of establishing a pet trust) and charitable organizations, charities one could assume would see an increase in contributions under the pet trust CRAT charitable remainder exception.\textsuperscript{221} Congress could also extend the benefits to pet owners by allowing CRAT pet trusts to be exempted from income taxes on income and distributions during the lifetime of the pet because, in essence, the

\begin{itemize}
  \item \textsuperscript{218} \textit{See supra} Part III.
  \item \textsuperscript{219} \textit{See supra} notes 46-49 and accompanying text.
  \item \textsuperscript{220} \textit{See supra} notes 193-197 and accompanying text; \textit{see also} Jonathan P. Wilkerson, \textit{A “Purr”fect Amendment: Why Congress Should Amend the Internal Revenue Code to Apply the Charitable Remainder Exception to Pet Trusts}, 41 Tex. Tech. L. Rev. ___ (forthcoming 2009) (advocating for the adoption and passage of the Morgan Bill and outlining the benefits for pets and pet owners)
  \item \textsuperscript{221} \textit{See Wilkerson, supra} note 220.
\end{itemize}
money is a charitable contribution once the pet passes away.\textsuperscript{222} Finally, Congress should consider applying the IRS income tax rate for statutory pet trusts (married individual filing separately) to traditional pet trusts and honorary pet trusts as well.\textsuperscript{223}

\section*{VII. CONCLUSION}

Favorable pet trust laws and modern developments are ushering an exciting time to be a practicing attorney. But amendments to tax laws for pet trusts and the associated complexities should cause practitioners to stop, ask their clients questions, and examine the federal and state tax advantages or disadvantages of the structured pet trusts. Each pet trust type has its own income, gift, and estate tax considerations to ponder.\textsuperscript{224} As baby boomers continue to retire, many of them as pet owners who treat their pets as family members, practitioners should add “pet planning” to their list of estate planning services\textsuperscript{225} Ms. Helmsley’s attorney did—and Trouble sure is thankful.\textsuperscript{226}

\begin{itemize}
\item \textsuperscript{222} See id.
\item \textsuperscript{223} See id.
\item \textsuperscript{224} See supra Parts III-V.
\end{itemize}