

GRATs

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2022-2

A Chief Counsel Advice (CCA 202152018) has been issued concerning a GRAT. A section captioned "Facts" states:

Donor is the founder of a very successful company, Company. At the end of Year 1, Donor contacted two Investment Advisors to explore the possibility of finding an outside buyer. The facts indicate that, "[T]he Company was marketed through outreach by investment bankers to potential strategic buyers, some of which had previously expressed an interest in partnering with [Company]. Meetings were then scheduled to introduce [Company] and determine if there was additional interest." Potential buyers were expected to purchase a minority stake of Company with a call option after several years to acquire the remainder of Company at a formula valuation.

In Year 2, approximately six months later and within a two-week period concluding on Date 1, the Investment Advisors presented Donor with an offer from each of Corporation A, Corporation B, Corporation C, Corporation D, and Corporation E (collectively, the Corporations).

Three days later, on Date 2, Donor created Trust, a two-year grantor retained annuity trust (GRAT), the terms of which appeared to satisfy the requirements for a qualified interest under §2702 and the corresponding regulations. Under the terms of Trust, the trustee was to base the amount of the annuity payment on a fixed percentage of the initial fair market value of the trust property. Donor funded Trust with a shares of Company. The value of the shares of Company was determined based on an appraisal of Company on December 31, Year 1, a date approximately seven months prior to the transfer to Trust. The appraisal, which was obtained in order to satisfy the reporting requirements for nonqualified deferred compensation plans under §409A of the Code, valued the shares of Company at \$w per share.

Additional time was granted to the Corporations to submit final offers. The last offer was received on Date 3, almost three months after the initial offers. Corporations A through D raised their offers, while Corporation E withdrew from the bidding, expressing no further interest.

On Date 4, Donor gifted Company shares to a separate charitable remainder trust and valued those shares at \$x per share pursuant to a qualified appraisal. This per share value was equal to the tender offer value described below.

Three months after the new offers were received and several weeks after the transfer to his charitable remainder trust, Donor accepted Corporation A's offer, which represented a 10 percent increase over its initial offer. Per the final offer, an initial cash tender offer was made of \$x per share, an amount that was nearly three times greater than \$w (the value determined as of December 31, Year 1). During the tender period, Donor tendered b shares, while Donor's charitable remainder trust also took advantage of the tender offer.

On December 31, Year 2, Donor again had Company appraised for purposes of §409A and the new appraised value was \$y per share, which was almost twice the previous year's value of \$w per share. These steps were repeated for a December 31, Year 3 appraisal with similar results. The December 31, Year 2 and Year 3 appraisals both included the following language: "[a]ccording to management, there have been no other recent offers or closed transactions in Company shares as of the Valuation Date." There was no such declaration in the December 31, Year 1 appraisal.

In Year 4, approximately six months after the end of Trust's two-year GRAT term, Corporation A purchased the balance of the Company shares for \$z per share, a price almost double the value of \$y.

The record as compiled to date supports the proposition that, as of Date 1, the hypothetical willing buyer of the Company stock could have reasonably foreseen the merger and anticipated that the price of Company stock would trade at a substantial premium over \$w per share. When asked to explain the use of the outdated appraisal (as of December 31, Year 1) to value the transfer to the GRAT, as well as the use of a new appraisal to value the transfers to charity, the company that conducted the appraisal stated only that "[t]he appraisal used for the GRAT transfer was only six months old, and business operations had not materially changed during the 6-month period . . . For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than \$5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations of [Company] stock to various charities on [Date 4]."

To summarize, the Donor funded the GRAT with stock of a successful company. In the prior year, the company had considered selling to outside buyers with help from an investment advisor. On the date the GRAT was created, five open offers had been received. Several bidders raised their offer prices. The Donor determined his retained interest using a valuation obtained for reporting requirements covering nonqualified deferred compensation purposes, IRC Sec. 409A, as of the end of the prior year which was about seven months before the GRAT funding date. The company accepted an offer and the Donor sold a part of his shares for three times the value determined by the GRAT appraisal. A year later, the remainder of the company was sold at a price four times the appraised value.

The CCA describes the issues as:

1. Whether, under the circumstances described below, the hypothetical willing buyer and willing seller of shares in a company would consider a pending merger for purposes of valuing stock for gift tax purposes.
2. Whether Donor retained a qualified annuity interest in Trust when Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

The CCA's conclusions are:

1. Yes. Under the fair market value standard, the hypothetical willing buyer and willing seller of a company would consider a pending merger when valuing stock for gift tax purposes.
2. No. The retained interest is not a qualified annuity interest under §2702 of the Internal Revenue Code (Code) because Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

The "Law" section of the CCA makes two main points. The first states that:

The principle that the hypothetical willing buyer and willing seller are presumed to have "reasonable knowledge of relevant facts" affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property. *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 777 Fed. Appx. 870 (9th Cir. 2019). In addition, both parties are presumed to have made a reasonable investigation of the relevant facts. *Id.* Thus, in addition to facts that are publicly available, reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during negotiations over the purchase price of the property. *Id.* Moreover, a hypothetical willing buyer is presumed to be "reasonably informed" and "prudent" and to have asked the hypothetical willing seller for information that is not publicly available. *Id.*

Generally, a valuation of property for Federal transfer tax purposes is made as of the valuation date without regard to events happening after that date. *Ithaca Trust Co. v. United States*, 279 U.S. 151 (1929). Subsequent events may be considered, however, if they are relevant to the

question of value. *Estate of Noble v. Commissioner*, T.C. Memo. 2005-2 n.3. Federal law favors the admission of probative evidence, and the test of relevancy under the Federal Rules of Evidence is designed to achieve that end. *Id.* Thus, a post-valuation date event may be considered if the event was reasonably foreseeable as of the valuation date. *Trust Services of America, Inc. v. U.S.*, 885 F.2d 561, 569 (9th Cir. 1989); *Bank One Corp.*, 120 T.C. 174, 306. Furthermore, a post-valuation date event, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. See *Estate of Gilford v. Commissioner*, 88 T.C. 38, 52-55 (1987).

Two cases are mentioned and discussed. They are *Silverman v. Commissioner*, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert. denied*, 431 U.S. 938 (1977) and *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997).

The second main point is that a “qualified interest” under the requirements of Treas. Reg. §25.2702-3(b) and (d) is needed and was not met. The CCA states:

In *Atkinson v. Commissioner*, 115 T.C. 26, 32 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), a donor created a charitable remainder annuity trust (CRAT) but no payments were actually made from the trust to the donor during the two-year period between the creation of the trust and the donor’s death. The Commissioner argued that the trust was not a valid CRAT under §664(d)(1) and the corresponding regulations because the required annual annuity amount was never paid. The Tax Court agreed, concluding that although the terms of the trust met the letter of the statutory requirement providing for five percent annual distributions, the trust did not operate in accordance with those terms. Specifically, the Tax Court determined that the trust did not meet the express five percent requirement of the statute and could not qualify for treatment as a charitable remainder trust. On appeal, the estate argued that the deduction was being denied because of a “foot fault,” or a minor mistake. The Court of Appeals disagreed, however, and affirmed the Tax Court, holding that the trust failed to comply with the rules governing CRATs throughout its existence. Because these rules in §664(d)(1) and the corresponding regulations were not scrupulously followed throughout the life of the trust, a charitable deduction was not appropriate. *Atkinson*, 309 F.3d at 1295.

The current case shares many factual similarities with *Ferguson*, *supra*, for example, the targeted search by Donor to find merger candidates, the exclusive negotiations with Corporation A immediately before the final agreement, the generous terms of the merger, and an agreement that was “practically certain” to go through. While the *Ferguson* opinion deals exclusively with the assignment of income doctrine, it also relies upon the proposition that the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through. See *Bank One* and *Kollsman*, *supra*.

Further, the current case presents an analogous issue, that is, whether the fair market value of the stock should take into consideration the likelihood of the merger as of the date of the transfer of the shares to Trust. The *Ferguson* and *Silverman* opinions, as considered by the Tax Court and the Ninth Circuit and Second Courts of Appeal, respectively, support the conclusion that the value of the stock in Company must take into consideration the pending merger. Accordingly, the value determined in the December 31, Year 1 appraisal does not represent the fair market value of the shares as of the valuation date. Under the fair market value standard as articulated in §25.2512-1, the hypothetical willing buyer and willing seller, as of Date 2, would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation, and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT.

In addition, although the governing instrument of Trust appears to meet the requirements in §2702 and the corresponding regulations, intentionally basing the fixed amount required by §2702(b)(1) and §25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee’s failure to satisfy the “fixed amount” requirement under §2702 and §25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market

value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.

The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under §2702. See *Atkinson*.

Not all proposed transactions close, even those which seem likely to. The ruling does not develop the underlying facts in sufficient detail to enable an analysis of the likelihood of the tender offer being finalized when the GRAT was formed although that would be relevant in determining the correctness of the holding.

Many GRATs contain a provision to make an adjustment when values are finally determined after a gift tax audit. For example, trust forms of a large bank state “the trustee shall pay to the grantor an amount equal to ___ percent of the original net fair market value of the trust property, as finally determined for gift tax purposes as of the date of the transfer to the trustee of the property described on Schedule A.” The CCA does not quote the trust language but it seems unlikely that it contained such an adjustment provision.

The suggested language referring to a change made by a gift tax audit should be accepted because similar language in referring to marital deduction changes has been recognized for many years. If no change is made, the value used would become final upon the expiration of the three-year statute of limitations for a gift tax change.

Also, the CCA does not discuss IRC Sec. 6662 which imposes an addition to tax on the portion of the “underpayment to which [the section] applies” to a substantial gift tax valuation understatement. The addition is 40 percent if the gross valuation misstatement rule of subsection (h) applies.

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