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Update on Issue 2022-2 Regarding GRATs

May 10, 2022

2022-4

A. Introduction

Issue 2022-2 discussed CCA 201939002 which took the position that a zeroed-out GRAT was invalidated as a result of a failure to disclose relevant facts relating to its execution. Additional activity has occurred with the case. The IRS sent a Notice of Deficiency to the creator of the GRAT who has petitioned the Tax Court for a redetermination of the gift tax deficiency of almost $7.3 million and an IRC Sec. 6662 penalty of almost $1.5 million. The case is *Daniel R. Baty v. Comm'r*, Docket No. 12216-21. On March 24, 2022, Petitioner filed with the Tax Court a memorandum in support of his motion for summary judgment.

B. Facts

The Petition of the taxpayer to the Tax Court discussed some of the facts as follows:

In 1993, Petitioner Dan Baty co-founded Emeritus Senior Living ("Emeritus"), an operator of freestanding assisted living communities. Declaration of Daniel Baty ("Baty Decl.") at ¶2. Over the next two decades, the company evolved from a small, regional player into a company with almost $2 billion in annual revenue. By 2013, Emeritus had become one of the nation's largest assisted living and memory care providers, with the capacity to serve over 50,000 residents in 483 communities across 45 states. Baty Decl. at ¶3.

Emeritus shares were actively traded on the New York Stock Exchange, the world's largest (by market capitalization of its listed companies) and most liquid stock exchange. During the month of January 2014, approximately 5.69 million shares of Emeritus were traded on the NYSE (under the ticker symbol ESC), with the daily volume of shares being traded ranging between 104,000 and 493,000. Declaration of Evin Morris ("Morris Decl.") at ¶4.

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As Emeritus' Chairman of the Board, Petitioner was aware of (and participated in) the ongoing merger negotiations with Brookdale, though he was not part of the team tasked with day-to-day negotiations. Pursuant to the securities laws, Petitioner and other insiders with knowledge of the merger negotiations were barred from trading during the pendency of the negotiations or disclosing such information to third parties. Baty Decl. at ¶13; *United States v. Chow*, 993 F.3d 125, 136-39 (2d Cir. 2021); *United States v. O'Hagan*, 521 U.S. 642, 654-60, 117 S. Ct. 2199 (1997).

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Under a heading "Facts Regarding Penalties" the Petition states:

bb. In connection with the filing of the gift tax return, the Petitioner was advised by and relied upon tax professionals who were aware that Emeritus had announced its merger with Brookdale a few short weeks after the GRAT had been established and had subsequently consummated the merger a few months later.

cc. Petitioner was advised by his professional advisors and genuinely believed that his 2014 gift of publicly traded stock was required to be valued following the average high/low value rule set out in Treas. Reg. §25.2512-2(b)(1). The regulation requires that, if there was trading on the day of transfer, the value shall be the mean between the highest and lowest quoted selling prices.

dd. Petitioner had no reason to think that any other valuation method was appropriate, nor was he advised that any other valuation method might be appropriate. There had been no prior cases or rulings which had rejected the use of NYSE market prices of the exact stock in question set on the exact day in question on the notion that non-public information known by Petitioner made the standard market valuation method set out in the regulations inappropriate.

ee. Here, there is no controlling legal authority or guidance supporting the position taken by the Commissioner (though there are several cases supporting the position taken by the Petitioner). During the audit, the IRS sought Chief Counsel's Advice with respect to whether the IRS could take the position that the NYSE market price on the date of contribution to the GRAT was not controlling. The Office of Chief Counsel responded affirmatively, placing significant reliance on "assignment of income" cases. See CCA 201939002. As the issues involved in this case are complex and the IRS is advancing a novel position, the conclusion that Petitioner had reasonable cause with respect to the valuation issue is inescapable.

ff. Petitioner acted with reasonable cause and good faith.

gg. Petitioner was not negligent in the preparation of the gift tax return, nor did he disregard the rules and regulations within the meaning of Sections 6662(b)(1) and 6662(c).

C. Discussion

The Introduction of Petitioner's memorandum states:

This case concerns the valuation of shares in a public company traded on the New York Stock Exchange. Petitioner was the company's Chairman of the Board. Petitioner contributed the shares at issue to a grantor retained annuity trust ("GRAT") at a time when the company was involved in non-public merger negotiations with a publicly traded competitor. Under the securities laws, [SEC Rule 144, 17 C.F.R. §230.144] during the pendency of the negotiations, persons involved in the merger negotiations (including Petitioner) were generally precluded from trading in the stock and had a duty not to disclose the existence of the non-public merger negotiations to third parties.

In his Notice of Deficiency, Respondent determined that the average of the daily high and low public market values required by Treas. Reg. §25.2512-2(b)(l) (which Petitioner employed in determining the value of the GRAT contribution) was inapplicable. Instead, Respondent argued that the fair market value should be adjusted upwards based upon the ongoing merger negotiations, the existence of which were not known to the public at the time of the contribution. Respondent determined that the value of the GRAT contribution should be based on the stock's trading price on the merger date, which was more than six months after the GRAT contribution.

Assuming *arguendo*, solely for purposes of this motion, that information about the merger negotiations would have increased the market value of the stock if it had been generally known, under the statute, regulations, and controlling case law, the IRS is not permitted to substitute its speculation about what the "fair market value" of the stock might have been (if the non-public information known by Petitioner and other insiders were more widely known) for the actual trading price of the stock on the date of the GRAT contribution.

Because the facts are not reasonably in dispute, Petitioner seeks summary judgment that the average of the high and low prices of an actively traded stock on the date of a GRAT contribution produces the correct value of the stock for gift tax purposes, as required by Treasury Regulation §25.2512-2(b)(l). Respondent's contentions otherwise are contrary to both longstanding case law assigning primacy to the value determined by an active market as well as the definition of "fair market value" set out in the regulations.

While the overwhelming majority of gift and estate tax valuation cases involve questions of fact that are not amenable to summary disposition, in this case, the extreme position taken by Respondent in rejecting the value of the stock as determined by the public market makes it uniquely suited for summary judgment.

In the CCA, the IRS cites *Kollsman v. Comm'r*, T.C. Memo 2017-40, in support of its position. Petitioner's memorandum discusses the case as follows:

In CCA 201939002, to support the assertion that a reasonable buyer would have uncovered facts beyond those that were publicly available, Respondent cited *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40. The "non-public facts" in *Estate of Kollsman* related to the condition of Old Master paintings (i.e., whether the paintings were amenable to cleaning), a fact which presumably a buyer would have been able to find out from a seller.

The non-public information discussed in *Estate of Kollsman* is not the type of "non-public" information about a publicly traded stock whose dissemination is proscribed by securities laws. Indeed, the phrase "non-public information" has a technical meaning under the securities laws that is quite different from the informal way that *Estate of Kollsman* articulated the "reasonably informed" aspect of the hypothetical buyer/seller test to include facts beyond those that were publicly available.

The hypothetical buyer is not expected to be omniscient, only "reasonably well informed" about the property. Even the *Estate of Kollsman* court did not take the position that being "reasonably well informed" meant that the hypothetical buyer would uncover all of the facts. The *Estate of Kollsman* court held that knowledge of certain facts about the property could not be attributed to the hypothetical purchaser:

We do not believe that the results of window tests [which would provide additional information about the condition of the paintings] would constitute reasonable knowledge of relevant facts because the window tests were invasive and the hypothetical willing seller would not necessarily have agreed to them.

Id. at *25, fn. 18. The hypothetical purchaser is thus not assumed to know all of the facts concerning the property, but merely to have made diligent inquiry, which includes making *reasonable* requests of the seller for additional information during negotiations about the sales price.

In valuing assets, the courts have held that having "reasonable knowledge of the facts" does not necessarily extend to facts that were being held under wraps by another party. *Estate of Foster v. Commissioner*, T.C. Memo. 2011-95, 2011 Tax Ct. Memo LEXIS 91, at *29-30. In *Estate of Foster*, a law firm was hired by the estate shortly after the decedent's death to investigate potential causes of action against a former attorney for the decedent who had arranged a loan from an insurance policy owned by three marital trusts, the proceeds of which had been used to shore up a company owned by the decedent, but which ultimately had unfavorable consequences for the decedent. While it looked beyond the former attorney to other potentially responsible parties, the law firm initially believed that the estate did not likely have a valid claim against the trustee of the marital trusts (Northern Trust) with respect to this transaction.

Ultimately, more than a year and a half after the decedent's death, the law firm obtained information from Northern Trust that suggested the trustee may have failed to investigate the merits of the insurance transaction and failed to advise the decedent about valuable rights that she was relinquishing in the insurance policy loan transaction.

Subsequent discovery over the following six months produced documents (some of which had been initially withheld as privileged) that suggested that Northern Trust's legal department had neglected to inform its trust department of the fact that Northern Trust's lending department had disregarded the firm's conflict of interest arising from its roles as trustee of the marital trusts and as a creditor of the decedent's company. The case ultimately settled for more than $17 million, and the IRS asserted an adjustment to the estate tax based on valuing the claim against Northern Trust at that amount ($17 million) as of the date of death.

The IRS and its expert recognized that the law firm had "put together a huge jigsaw puzzle" as it uncovered and refined the estate's claims against Northern Trust, but the Commissioner's expert nevertheless took the position that "the hypothetical purchaser would have knowledge of all of the facts in Northern Trust's files, including specifically those discovered by the estate's counsel after time-consuming and contested discovery." *Estate of Foster*, 2011 Tax Ct. Memo LEXIS 91, at *29-30. The Tax Court disagreed with the IRS's position that the facts were "knowable" by a hypothetical purchaser on the date of death, reasoning that it was improper to treat the hypothetical buyer as being omniscient, especially when the relevant facts were in the possession of a party who was loathe to disclose such details. *Id*. at *30.

Here, the shares at issue were held by an insider who was not permitted to disclose the existence of the merger talks. While a hypothetical purchaser would have been free to inquire about the possibility that Emeritus was seeking to sell itself to a merger prospect, no one (neither Baty nor anyone else privy to the merger negotiations) could have disclosed that information without violating securities laws.

The CCA also cites *Silverman v. Comm'r*, T.C. Memo 1974-285, aff'd, 538 F.2d 927 (2d Cir. 1976), *cert. denied*, 431 U.S. 938 (1977). Petitioner's memorandum discusses *Silverman* as follows:

In his CCA, Respondent cited *Silverman v. Commissioner*, T.C. Memo. 1974-285, 1974 Tax Ct. Memo LEXIS 35, *aff'd*, 538 F.2d 927 (2d Cir. 1979), *cert. denied*, 431 U.S. 938 (1977), for the proposition that the post-merger value of Brookdale shares should be the basis for valuing pre-merger agreement Emeritus shares. In *Silverman*, the donor had complete control of the corporation and was in the process of recapitalizing his closely held company in preparation for an IPO at the time when he made the gifts at issue. The Tax Court criticized the valuation by the taxpayer's expert for failing to account for the fact that the closely held company was in the process of reorganizing in order to go public. Like *Estate of Kollsman* and the cases cited therein, *Silverman* did not involve information about public companies that the law barred insiders from sharing or trading on.

To Petitioner's knowledge, the only persons aware of the merger negotiations between Emeritus and Brookdale were insiders of the two public companies and their advisors, who were barred from disclosing the existence of the non-public negotiations to anyone who might use the information for trading purposes or trading on it themselves. Baty Decl. at, ¶13.

Indeed, over the last several years, the SEC has filed hundreds of enforcement actions against persons who "tipped" others by disclosing material non-public information concerning public companies. On the criminal side, insider trading including tippee cases-is one of the priorities of the DOJ Criminal Division. To uncover such insider trading cases, the SEC and FINRA analyze trading patterns in order to investigate suspicious trades, which might be based on insider information.

For the hypothetical buyer to ascertain the existence of the merger negotiations, Respondent's position requires that someone close to the transaction not only violate his or her fiduciary duty and disseminate non-public information, but also expose themselves to the very real prospect of civil penalty and/or criminal conviction. Respondent's assertion that a reasonably informed hypothetical purchaser would have learned about the merger talks in the purchaser's negotiations for the purchase of the asset (Emeritus shares) is implausible and unsupportable.

Moreover, consider the situation where a hypothetical purchaser learned about the existence of non-public information regarding the Emeritus/Brookdale merger negotiations, and believed that the non-public information suggested that the Emeritus stock was being misvalued by the market (as Respondent asserts), and was willing to violate securities laws by trading on this information. Assuming that the non-public information suggested a higher value for the stock, this hypothetical buyer would be unwilling to trade off-market with a hypothetical seller who was similarly informed at the above-market premium Respondent suggests was appropriate on January 14, 2014, because the hypothetical purchaser could acquire the same stock on the non-hypothetical NYSE market, which had many real sellers willing to sell at much lower share prices on January 14, 2014.

The Commissioner also relies upon *Ferguson v. Comm'r*, 174 F.3d 997 (9th Cir. 1999). Petitioner's memorandum discusses *Ferguson* as follows:

Respondent misreads *Ferguson*. The question in *Ferguson* was whether a taxpayer holding stock, which was the subject of an all-cash tender offer received from a third party, had received "income" such that the transfer of the shares subject to the tender-prior to all of the formalities of the tender offer having been met-would be treated as an "anticipatory assignment of income." The *Ferguson* court explained:

To determine whether a right has "ripened" for tax purposes, a court must consider the realities and substance of events to determine whether the receipt of income was practically certain to occur (i.e., whether the right basically had become a fixed right).

174 F.3d at 1003.

In determining that the right to participate in the tender was "practically certain" and "fixed" prior to the gifting, the Ninth Circuit explained:

[I]n defending its selection of August 31, 1988, as the relevant date for the ripening of the AHC stock, the Tax Court considered whether, as of that date, the surrounding circumstances were sufficient to indicate that the tender offer and the merger would proceed, as if both had to be completed as of or on that date. **For example, the Tax Court initially noted that, as of August 31, 1988, over 50% of the outstanding AHC shares had been tendered, and then the Tax Court noted that the receipt of this amount alone was sufficient to ensure that DC Acquisition would accept the tendered stock and thus unilaterally could and would proceed with the merger.**

174 F.3d at 1004 (Emphasis added).

The critical question in anticipatory assignment of income cases is thus "whether the prospective acquisition is a mere expectation or a virtual certainty." *Chrem v. Commissioner*, T.C. Memo. 2018-164 at *5 (citing *Greene v. Commissioner*, 13 F.3d 577, 582 (2d Cir. 1994)). While Petitioner and other insiders may well have **expected** a future merger in January of 2014 while negotiations were happening, there was no **virtual certainty** that it would, in fact, occur at all-not to mention the substantial uncertainty about the material terms of any such potential merger.

There are no "assignment of income" cases that can be read to suggest that a future corporate transaction was "practically certain" to occur, based solely on the existence of negotiations and in the absence of any agreement. While the Ninth Circuit opinion in Ferguson adopts a practical-rather than a hyper-technical-approach in determining **when** an agreement fixing value has been reached, it does not support the notion that value could be fixed prior to the time of an actual agreement between the parties.

Apparently relying on *Ferguson*, Respondent also selected the value of the Emeritus/Brookdale stock on the merger date (July 31, 2014) as the value of the Emeritus stock at the time of the contribution to the GRAT (January 14, 2014). This is nonsensical for a number of reasons:

(1) As of January 14, 2014, the final price/share exchange ratio had not yet been finally negotiated. Brookdale subsequently succeeded in adjusting the exchange ratio downward from 1:1 to 1:0.95 (though Brookdale's insistence on this change nearly caused the merger discussions to collapse);

(2) Unlike *Ferguson*, where the tender price was fixed in dollars, what would ultimately be received by Emeritus shareholders depended entirely on the future share price of Brookdale, which in turn depended significantly on whether the public market thought that the merger was a good move; and

(3) No one (not Petitioner, not an appraiser, and not even an Einstein-level economics genius) had the ability to prognosticate-with any degree of accuracy-the Brookdale stock price six months into the future (when it might also include Emeritus assets). Morris Decl. at, ¶¶17 and 18.

C. Conclusions

We understand the IRS' concern regarding zeroed-out GRATs. However, the problem was created by a failure of staff to understand what could be done under IRC Sec. 2702 before it was enacted. The IRS has acquiesced as to zeroed-out GRATs (see *Walton v. Comm'r*, 115 T.C. 589 (2000), acq. IRS Notice 2003-72). Until the law is changed, the acquiescence should be respected without taking unreasonable positions regarding such trusts. The position taken in CCA 201939002 as to the asserted penalty is not reasonable. We believe there is a good chance Petitioner will succeed with his summary judgment motion as to the penalty.

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related professionals

Jerome J. Caulfield / Partner
D 212 238-8809
caulfield@clm.com