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The Washington Report

Wealth Transfer Edition

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The IRS Takes an Unprecedented Position Against Perceived GRAT Valuation Abuse

MARKET TREND: Abusive taxpayer transactions simply continue to raise the ire of the IRS. Commonly seen as a very conservative planning technique, the Internal Revenue Service ("IRS") has recently taken extreme positions to challenge the use of grantor retained annuity trusts ("GRATs").

SYNOPSIS: The IRS in a recent CCA takes the position that by undervaluing the assets transferred to a GRAT, the GRAT annuity interest is not a "qualified interest," and therefore the entire transfer is a taxable gift. The IRS finds that the transferred interest can be undervalued to such an extent that it ceases to be a qualified interest under IRC § 2702.

TAKE AWAYS: While the CCA is not precedent, it is a clear indication of how the IRS may deal with perceived abusive (valuation) transactions. A softer touch could have permitted use of the self-adjustment regulations to correct the transaction. Instead, the IRS uses a hammer to address, in our view, bad taxpayer behavior. To avoid costly disputes with the IRS, when funding a GRAT or any irrevocable trust with hard-to-value assets, obtain a qualified appraisal as of the date of the transfer.

MAJOR REFERENCES: Chief Counsel Advice 202152018 (the "CCA"); Internal Revenue Code ("IRC") § 2702.

The CCA takes the position that by undervaluing the assets transferred to a grantor retained annuity trust, the GRAT annuity interest is not a qualified interest under the applicable rules, and the entirety of the transfer is therefore, a taxable gift. The IRS takes certain liberties, such as explaining away its own regulations, to reach this conclusion.

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Basics: Some Fundamentals

What's a GRAT?

A GRAT is an irrevocable trust largely created to remove the gifted assets' future appreciation from the creator's personal balance sheet. A grantor, in this instance, contributes assets with appreciation potential to a fixed-term trust. The grantor retains the right to receive an annuity stream over the trust's term (e.g., 2 years) and at the end of the term the assets are distributed to noncharitable beneficiaries, typically the grantor's children. If the trust-owned assets appreciate at a rate greater than the applicable IRC § 7520 rate in effect the month the assets were transferred to the trust, then any appreciation in excess of such IRC § 7520 rate passes to the beneficiaries free of gift tax.

GRATs are popular because they represent an opportunity for a family to transfer appreciating assets to the next generation with little or no gift or estate tax consequences. GRATs also are typically viewed as having little downside risk because they are creatures of statute.

Section 2702

Normally retaining a right to receive income from a gift causes the gift to be ignored for gift tax purposes, meaning the asset is still part of the donor's taxable estate. GRATs are, in effect, an exception to this rule and are allowed by a statute (IRC § 2702).

However, failure to follow the rules for this statutory exception can be stiff. In fact, IRC § 2702(a)(2)(A) provides that the value of any retained interest which is not a "qualified interest" is treated as being zero. This means the entire value will be deemed transferred to the remainder holders (the beneficiaries) regardless of the retained interest. For example, if a donor transfers assets worth $1,000,000 to a trust for the benefit of his children, and retains an interest worth $500,000, the entire $1,000,000 is treated as the value of the gift for tax purposes.

IRC § 2702(a)(2)(B) provides that the value of any retained interest which is a "qualified interest" shall be determined under section 7520. This is a GRAT.

A "qualified interest" is effectively defined in IRC § 2702 to mean:

- Any interest which consists of the right to receive fixed amounts payable not less frequently than annually,

- Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and

- Any noncontingent remainder interest if all of the other interests in the trust consist of the interests described in the first two bullets above.

If any retained interest does not strictly meet the definition of a "qualified interest" above, then it falls back into the default treatment of IRC § 2702(a)(2)(A) and is valued at zero.

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Self-Adjusting GRAT Regulations – Fixing a Broken GRAT

The IRS provides rules to assist the donor/taxpayer just in case the initial asset valuation is erroneous. These IRS regulations permit the GRAT annuity to "self-adjust" if the valuation is incorrect. When the annuity is expressed as a percentage of the fair market value, the annuity amount should adjust so that the value of the transfer for gift tax purposes remains substantially unchanged.

Treasury Regulation § 25.2507-3(b)(1)(ii)(B) provides, in part, that a "fixed amount" means a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, *as finally determined for federal tax purposes*, payable periodically but not less frequently than annually.

Treasury Regulation § 25.2702-3(b)(2) provides that if the annuity is stated in terms of a fraction or percentage of the initial fair market value of the trust property, the governing instrument must contain provisions meeting the requirements of § 1.664-2(a)(1)(iii) of this chapter (relating to adjustments for any incorrect determination of the fair market value of the property in the trust).
The bottom-line: an erroneous valuation can normally be corrected without penalty.

CCA 202152018: A completely new direction

Facts

The CCA involves the founder ("**Donor**") of a very successful company, "**Company**." Donor transferred shares of Company into a GRAT in accordance with the following timeline:

- **End of Year 1**: Donor contacts investment advisors to explore possibility of finding an outside buyer for Company.

- **December 31, Year 1**: Company obtains valuation of $<u>w</u> per share for IRC § 409A purposes ("**Year 1 409A Appraisal**");

- **Approx. June 15, Year 2[1]:** The investment advisors present Donor offers from five corporations to purchase the Company;

- **Approx. June 18, Year 2:** Three days after receiving offers, Donor creates a two-year GRAT and funds with shares of Company. The share value was based off the Year 1 409A Appraisal dated almost 7 months prior.

- **Approx September Year 2:** The potential buyers submitted final offers with four raising their offers.

- **Approx. November Year 2**: Donor gifted Company shares to a separate charitable remainder trust ("**CRT**") and valued those shares at $<u>x</u> per share pursuant to a new qualified appraisal.

- **Approx. December Year 2**: Donor accepted an offer. Per the final offer, the initial cash tender offer was made at $<u>x</u> per share (the same value as used for CRT), an amount that was nearly three times greater than $<u>w</u> (the Year 1 409A Appraisal value).

[1] The date is approximated based off information contained in the CCA. The date is "approximately six months later [from the end of Year 1] and within a two-week period concluding on Date 1." When providing "approximate" dates in this article, the dates are estimates based off descriptions contained in the CCA (i.e., "three months after," etc.).

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- **December 31, Year 2 and 3**: Donor received an IRC §409A appraisal of $y per share. Donor received a similar result in Year 3. For both Year 2 and Year 3, the appraisal included the language, “according to management, there have been no other recent offers or closed transactions in Company shares as of the Valuation Date.”

- **In Year 4**: Approximately six months after the end of the two-year GRAT, the purchasing corporation purchased the balance of the Company’s shares for $z per share, a price almost double the value of $y.

The Issues

The following issues were addressed by the CCA: (1) should the pending merger have been considered for valuing the stock for gift tax purposes; and (2) whether Donor met the IRS guidelines for a qualified annuity interest when Donor used an outdated appraisal that did not take into account all of the facts and circumstances of a pending merger. The CCA’s answer to these questions was “yes” and “no,” respectively.

Law and Analysis

(1) **Consideration of Pending Merger**

The CCA relies on an old assignment of income case[2] to conclude that the Company stock appraisal must reflect a pending merger. The CCA found that the merger agreement was “practically certain” to go through at the time of the transfer. Accordingly, the value of the Year 1 409A Appraisal did not represent the fair market value of the shares as of the transfer date.

(2) **Qualified Interest**

The CCA extended the logic of a case titled *Atkinson v. Commissioner,*[3] to the asset transfer. In *Atkinson*, a donor created a charitable remainder annuity trust, 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 Tax Court found that even though the terms of the trust met the letter of the statutory requirement for providing five percent annual distributions, the trust did not operate in accordance with those terms and thus, denied the donor a charitable income-tax deduction.

The IRS, in the CCA, similarly found that although the trust appeared to meet the terms of IRC § 2702, intentionally basing the required fixed annuity payment on an undervalued appraisal caused the retained interest to fail to function exclusively as a “qualified interest” from the creation of the trust. The CCA casts this undervaluation as an operational failure, similar to the nonpayment in *Atkinson*. As a result, the undervaluation resulted in such an artificially small annuity, and therefore a (gift tax-free) windfall for the remaindermen; the undervaluation was so great that the self-adjustment under the regulations would not be permitted because it rose to the level of an “operational failure.”

The harsh result of this CCA is that the entire transfer the Donor made to the GRAT is considered a taxable gift, resulting in an excruciating outcome for the taxpayer/Donor.

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[2] *See Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), aff’g 108 T.C. 244 (1997).
[3] 115 T.C. 26, 32 (2000), aff’d, 309 F.3d 1290 (11th Cir. 2002).

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Getting practical: How to proceed

The CCA, while in some respects is not surprising, it is unprecedented. The IRS has extended the *Atkinson* doctrine in such a way that overrides its own regulations. The IRS is likely using the CCA to send a very loud and clear message: the self-adjusting regulations do not give taxpayers carte blanche to take unreasonable valuation positions in GRAT transactions.

While the harsh result of this CCA is alarming, it is important to note that it is a CCA – it represents the IRS's interpretive guidance on a particular set of facts, but that said, it does show the IRS's view. Still, steps can be taken to avoid the IRS's wrath on a GRAT transaction.

An Easy Fix

1. **An Updated Appraisal**

The first misstep of the Donor in the CCA was using an appraisal that was 7 months old. The CCA didn't specifically say that 7 months is too old as a rule, but it is a best practice when transferring hard-to-value assets to get an appraisal dated as of, or close to, the transfer date, or if dealing with an old appraisal, have it updated.

When getting an appraisal, it is also important to provide all the facts, like a pending sale transaction. Let the valuation team assess the facts and use their expertise. If there are on-going merger discussions, tell the valuation team so they can weight them appropriately.

2. **A Qualified Appraisal**

The CCA did not address the fact that the appraisal relied upon was for IRC § 409A purposes and not gift tax purposes, but it is an important distinction.
While for purposes of IRC § 409A, appraisals are presumed to be the fair market value of the stock. Gift tax appraisals for closely held businesses are valued using factors set forth in Revenue Ruling 59-60. Additionally, the appraisal must meet the adequate disclosure regulations to run the statute of limitations against IRS challenge.

In short, gift tax appraisals and IRC § 409A appraisals have different purposes and should not be viewed as substitutes. Clients may want to save costs and use the IRC § 409A appraisal, but this may inject risk into otherwise conservative wealth transfer strategies.

3. **Take Consistent Valuation Positions**

The Donor used a value three times higher when transferring shares to a CRT than when transferring the very same shares to the GRAT. The Donor had defensible reasons for the discrepancy (the merger discussions had significantly progressed through a second round of offers at the time of the CRT), but the optics were bad. The IRS is going to be naturally skeptical when two different values are used, both of which benefit the taxpayer. In this case, the lower GRAT valuation allowed more value to be transferred to the remaindermen gift tax-free, and the higher CRT valuation gave Donor a larger charitable income tax deduction.

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If different valuation positions are being taken, certain practices can help minimize the risk of challenge. Employ the same valuation firm and have them use the same valuation method. By having consistency, an argument over a change in value may withstand scrutiny.

Take aways

While the CCA is not precedent, it is a clear indication of how the IRS may deal with perceived abusive (valuation) transactions. A softer touch could have permitted, by using the self-adjustment regulations, to correct the transaction. Instead, the IRS uses a hammer to address, in our view, bad taxpayer behavior. To avoid costly disputes with the IRS, when funding a GRAT or any irrevocable trust with hard-to-value assets, obtain a qualified appraisal as of the date of the transfer.

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