GRAT and Valuation Planning After CCA 202152018: What Practitioners Need to Know

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GRAT and Valuation Planning After CCA 202152018: What Practitioners Need to Know

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A Key Estate Planning Guide

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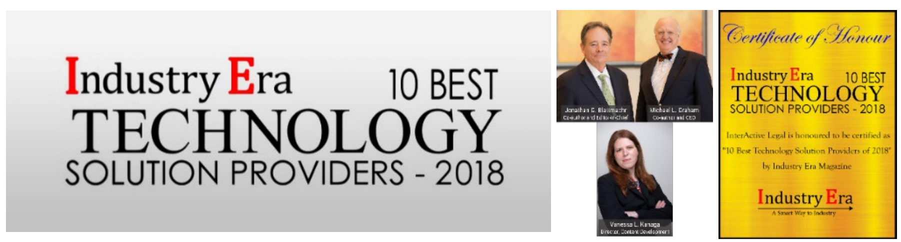

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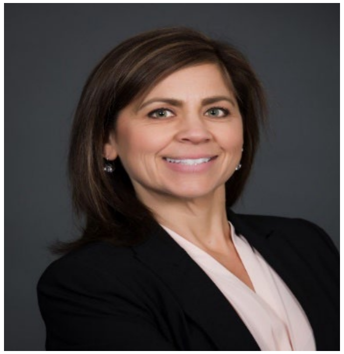

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Emerging Targets	Emerging Targets	Research Tools

Introduction and Overview

Overview of CCA

Overview and Introduction - 1

- CCA 202152018, released on December 30, 2021, could have a critical impact on grantor retained annuity trusts (GRATs). (Note: As the CCA notes, it cannot be cited or used as precedent.)
- The CCA addresses a common valuation challenge: what consideration should be given to a potential sale in valuing an asset. Often there is a long continuum from no sale, to discussions with potential buyers, to a letter of intent, to a binding contract, etc. Where the business is on the continuum will affect how an appraiser will evaluate the possible implications of the status of a potential sale.
- In the CCA, the possible sale had moved, according to the IRS, too far along the continuum towards an actual sale to have been ignored in the valuation. The CCA specifically held that “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.”

Overview and Introduction - 2

- As a result, the IRS applied the "reasoning" in the Atkinson (309 F 2d 1290 (11th Cir. 2002), affirming 115 TC 19), and held that the valuation was so wrong that the GRAT annuity was not qualified. Specifically, the CCA concluded: "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interest is not a qualified annuity interest under § 2702 of the Internal Revenue Code (Code) because Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger." But note that Atkinson had nothing to do with valuation—rather, it was the failure to "properly" administer the CRT.
- This would result in the entire amount transferred to constitute a taxable gift.
- What does this mean to GRAT planning generally?
- What might this mean to the use of GRATs as valuation spillovers receptacles in a defined value mechanism?
- Might this have implications to other aspects of defined value clauses?

Overview and Introduction - 3

- What might this CCA mean to valuations generally?
- Are there new steps and precautions practitioners might choose to take?
- Might this signal a broader application of the Atkinson principals to GRATs and CRTs generally?
- This program will include a detailed discussion of the CCA, analysis by an expert appraiser of the valuation implications, a discussion of Atkinson, and much more.
- Do the recent Smaldino case, Smaldino V. Commissioner Of Internal Revenue, T.C. Memo. 2021-127, November 10, 2021, and the CCA focusing on administration of a trust as in Atkinson, signal a new harsher focus by the IRS on trust and plan administration?

CCA Facts

Key Facts

Facts: Marketing the Company

- 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.
- What is the impact on the appraisal process of these facts?

Facts: Time Frame for Appraisal, Offers and Gift to GRAT

- 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**.
- What does this timeline mean to appraisals generally? To the instant CCA? What lessons must practitioners be cautious about?

Facts: Appraisers Comments That GRAT Appraisal Was Not Stale

- "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** . . "
- What makes an appraisal stale? Obviously, it is not only calendar time but intervening events? Does the CCA impact how old an appraisal might be before becoming stale if there are no intervening events? What might or should practitioners do to document no intervening events? What errors did the appraiser make in its comments about business operations? Did the appraiser know of the offers?

Facts: 409A Appraisal

- 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.
- What are the differences if any between a §409A appraisal and an appraisal for gift tax purposes? Will a §409A appraisal with nothing more satisfy the FMV definition for gift tax purposes? Will attaching a §409A appraisal meet the requirements of adequate disclosure and begin tolling the statute of limitations? See Reg. 301.6501(c)-1(f).

Facts: CRT Appraisal

- 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).
- How did the inconsistent valuation positions from the GRAT to the CRT influence the holding in the CCA? What lessons and cautions should practitioner learn from this?

Facts: Final Deal Price Compared to Value Used for GRAT

- 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).
- Does the difference in valuation from that used for the GRAT and the deal price itself have implications to planning (other than the disqualification of the GRAT annuity payment as discussed below)? Is there a benchmark that can be used that suggests a magnitude of valuation difference that will have adverse consequences? Is there a valuation differential that might avoid the harsh result of the CCA? If there is no bight line measure how should practitioners interpret this?

Further Discussion of the Law

What Issue of Law Were Analyzed in the CCA?

Law: What is FMV?

- Section 25.2512-1 of the Gift Tax Regulations provides, in part, that if a gift is made in property, its value at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both **having reasonable knowledge of relevant facts**.
- What does the definition of FMV mean and what should practitioners consider?
- What are relevant facts? What should be disclosed in an appraisal report? What steps might practitioners take to corroborate disclosure of relevant facts?

Law: Hypothetical Buyer and Seller

- The willing buyer and willing seller are hypothetical persons, rather than specific individuals or entities, and their characteristics are not necessarily the same as those of the donor and the donee. See Estate of McCord v. Commissioner, 120 T.C. 358 (2003), rev'd on other grounds, 461 F.3d 614 (5th Cir. 2006); Estate of Newhouse v.
- Commissioner, 94 T.C. 193 (1990). The hypothetical willing buyer and willing seller are presumed to be dedicated to achieving the maximum economic advantage. Newhouse, 94 T.C. at 218.
- These are not specific buyers so would a strategic buyer, which may have been the case in the CCA, be the relevant litmus test?

Law: What Facts Should the Hypothetical Buyer/Seller Know?

- 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.
- What facts might a reasonable buyer uncover? What should be done to corroborate this?

Law: Post Valuation Date Events

- 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).
- What must be considered? How should an appraiser reflect these events?

Law: What is “Post Valuation”

- Some practitioners endeavor to have an appraisal report be dated the date of the transaction. Is that feasible? If not what do appraisers recommend be done?
- If the appraisal report must logistically precede the transfer by several months or longer what might be done to address the gap period from the date of the appraisal to the date of the transfer?

Law: When Has a Merger/Sale Proceeded So Far that the Value Is Fixed at the Transaction Price?

- The Court of Appeals in Ferguson (174 F.3d 997 (9th Cir. 1999)) affirmed the Tax Court's conclusion that the transfers to charity and the foundations occurred after the shares in AHC had ripened from an interest in a viable corporation into a fixed right to receive cash and **the merger was "practically certain" to go through**. In particular, the 9th Circuit noted that "[t]he Tax Court really only needed to ascertain that as of [the valuation] date, the surrounding circumstances were sufficient to indicate that the tender offer and the merger were practically certain to proceed by the time of their actual deadlines - several days in the future." Ferguson, 174 F.3d at 1004. Consequently, the assignment of income doctrine applied, and the taxpayers realized gain when the shares were disposed of by the charity and foundations.
- There may be a myriad of variables. At what point might an appraiser reasonably consider the merger or other transaction to be assured? What if there are contingencies pending closing? Due diligence in process? How should the variables be evaluated and documented? If the appraiser in the CCA had documented the status of the proposed transactions but discounted them heavily because their remained legal means for the buyer to terminate, would the result have differed?

Law: What is a Qualified Annuity Interest?

- Reg. Section § 25.2702-3(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.
- Reg. Section 25.2702-2(b)(2) provides that the value(s) of a qualified annuity interest and a qualified remainder interest following a qualified annuity interest are determined under §7520.
- The value(s) of a qualified unitrust interest and a qualified remainder interest following a qualified unitrust interest are determined as if they were interests described in Reg. section 1.664-3.
- Reg. Section 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).

Law: What is a Qualified Annuity Interest?

- Reg. Section 25.2702-3(d)(1) provides that to be a qualified annuity interest, an interest must be a qualified annuity interest in every respect. Further, to be a qualified interest, the interest must meet the definition of and function exclusively as a qualified interest from the creation of the trust.
- Note that the CRT regulations provide: Requirement that trust must meet definition of <u>and function exclusively</u> as a charitable remainder trust from its creation. In order for a <u>trust</u> to be a charitable remainder <u>trust</u>, it must meet the <u>definition</u> of and *function exclusively as a charitable remainder <u>trust</u> from the creation of the <u>trust</u>.* (Reg. 1.661(a)(4).) (*<u>Emphasis added</u>*.) .
- The above is how the taxpayer lost in Atkinson and now the IRS applied the same reasoning to a GRAT. But unlike the CRT regulations there is no Regulatory requirement that a GRAT has to be administered perfectly.

Law: Atkinson

- 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.
- Might the IRS extend the Atkinson argument to more GRATs and GRAT issues?

Law: GRAT Annuity Not Qualified

- 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.
- This caused the entire GRAT to implode. Is this a challenge we may see more of? Might the IRS extend the Atkinson argument to more GRATs and GRAT issues?

Planning Implications

What Might the Ripple Effects of the CCA Be?

GRATs in General

- How should planners handle GRAT planning differently considering the CCA?
- Yet another untold story about the IRS attack on GRATs: An attempt to apply the Atkinson failure to operate property as to a GRAT (e.g., failure to pay the annuity within 105 days) cause the GRAT to fail from inception.
- ILS has anti-Atkinson language in its GRAT form. What it says…

GRATs in Defined Value Clauses

- Does the CCA change the analysis of using a GRAT versus, for example, an incomplete gift trust as the spillover receptacle in a defined value mechanism?

Valuations After the CCA

- How might appraisers and other professionals handle appraisals, especially if a sale or merger is under consideration?

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