Sale to Grantor Trust Transaction (Including Note With Defined Value Feature) Under Attack, *Estate of Donald Woelbing v. Commissioner* (Docket No. 30261-13) and *Estate of Marion Woelbing v. Commissioner* (Docket No. 30260-13)

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Overview

A very effective method of "freezing" an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member. Selling the appreciating assets to a grantor trust avoids the recognition of income on the initial sales transaction and as interest and principal payments are made on the note (at least as to payments made during the grantor's lifetime).

While sales to grantor trusts have been widely used for several decades, there have been audits in which the IRS takes the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the "economic realities of the arrangement … do not support a part sale," and that the full value of the partnership interest was a gift not reduced by any portion of the notes. (John Porter points out that he has seen this IRS approach in some prior audits, but this position conflicts with Treas. Reg. § 25.2512-8, which provides that transfers are treated as gifts "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore.")

The IRS and Treasury have expressed their discomfort with sale to grantor trust transactions by making dramatic legislative proposals in the 2013 and 2014 Administration's Revenue Proposals (narrowed in the 2014 Proposal to target sale to grantor trust transactions specifically).

In order for the sale transaction to be effective for estate tax purposes, it is important that the note that is given to the seller is recognized as "debt" rather than "equity." If the seller transfers assets to a trust and retains a beneficial interest in those assets, as opposed to merely being recognized as a creditor of the trust, the assets transferred will be included in the seller's gross estate for estate tax purposes. Also, the IRS takes the position that if the sale is not recognized as a "bona fide transaction," the IRS may treat the sale transaction as a gift by the seller and afford little or no value to the note that the purchaser gives to the seller to offset the amount of the gift.

Agents on occasion have questioned whether sales for notes bearing interest at only the meager AFR should be recognized. (There are some indications that the *Karmazin* case [discussed below], which received a great deal of attention in 2003, initially arose because of the agent's concern over use of the AFR as the interest rate on an intra-family sale transaction.)

The IRS is attacking some huge SCIN transactions in *Estate of Davidson.* See Item 39 of the Hot Topics and Current Developments Summary (December 2013) found here and available at www.Bessemer.com/Advisor).

The frontal assault on "standard" sale to grantor trust transactions comes to the forefront in two companion cases recently filed in the Tax Court.

Woelbing Estates Cases

The IRS is attacking sale to grantor trust transactions in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Comm'r*, Docket No. 30261-13; *Estate of Marion Woelbing v. Comm'r*, Docket No. 30260-13.

Facts. In 2006 Mr. Woelbing sold all of his non-voting stock in Carma Laboratories (a closely held company located in Wisconsin) to a trust (presumably a grantor trust) in return for a promissory note having a face value of about $59 million, bearing interest at the AFR. The purchase price was determined by an independent appraiser. The note contained a defined value provision stating that if the value of the stock is later determined by the Internal Revenue Service or a court to be different than the appraised value, the number of shares purchased shall automatically adjust so that the fair market value of the stock purchased equals the face value of the note.

The sale was made to an "Insurance Trust" that owned three life insurance policies on the lives of Mr. and Mrs. Woelbing. (The policies were subject to an "economic benefit regime" Split-Dollar Insurance Agreement, under which Carma Laboratories was obligated to pay the annual premiums on the policies, less the annual value of the economic benefit amounts. The decedent was obligated to pay the annual economic benefit amounts.) At the time of the sale in 2006, the policies had an aggregate cash surrender value of about $12.6 million, a portion of which could be accessed via policy loans or surrender of paid-up additions to make payments on the promissory note. Two Woelbing sons (who were beneficiaries of the trust) executed personal guarantees to the trust for 10% of the purchase price of the stock. The estate's position is that the trust-purchaser had substantial financial capability to repay the note even without considering the stock itself, and that this financial capability exceeded 10% of the face value of the promissory note. (It is not clear whether the 10% cushion included the personal guarantees or whether the trust's financial capabilities other than both the stock and the personal guarantees exceeded 10% of the note face amount.)

Mr. and Mrs. Woelbing filed gift tax returns for 2006, 2008 and 2009 making the split gift election; therefore, if the 2006 sale transaction had a gift element, the gift was treating as having been made one-half by each of the spouses for gift and GST tax purposes.

Mr. Woelbing died in July 2009 and Mrs. Woelbing died in September 2013 (interestingly, only two days after receiving the IRS's Notice of Deficiency for almost $32 million against Mrs. Woelbing for her gift tax). In the estate tax audit of Mr. Woelbing's estate, the gift tax return for 2006 (and several other years) was also audited.

Gift Tax Issues. The IRS asserts that the note should be treated as having a zero value for gift tax purposes and is contesting the underlying value of the stock in 2006 (asserting a value in 2006 of $116.8 million compared to the $59 million purchase price). The IRS Notice of Deficiency asserts that for gift tax purposes, "Section 2702 requires inclusion of the entire value of non voting shares … as gifts when they were sold… in exchange for a note." Thus, the IRS position is that the note should be treated as having a zero value under §2702. Alternatively, if §2702 does not apply, the Notice of Deficiency alleges that "the donor made a taxable gift equal to the difference between the fair market value of the Carma Laboratories, Inc. shares transferred to the … Trust, and the note received in exchange." (That wording raises the interesting issue of what shares of stock were transferred. Under the terms of the sales agreement, only that number of shares equal to the face amount of the note was transferred.)

Estate Tax Issues. For estate tax purposes, the IRS position is that the note should not be included as an asset of Mr. Woelbing's estate, but the stock that was sold should be included in the estate under both §§ 2036 and 2038 at its date of death value. The value of the stock, according to the IRS, had increased to $162.2 million at the time of Mr. Woelbing's death.

Tax and Penalties Deficiency. The Notices of Deficiency for both estates in the aggregate allege gift and estate tax liabilities over $125 million and penalties over $25 million (asserting both gift and estate tax understatement 20% penalties). There were a few other relatively minor valuation issues involved for other properties in addition to the stock sale transaction.

Gift Tax Arguments Similar to Those in Karmazin and Dallas*.* In *Karmazin v. Commissioner,* the IRS made similar §2702 arguments in attacking a sale of FLP units to a grantor trust. T.C. Docket No. 2127-03, filed Feb. 10, 2003. The IRS argued that the note payments should be treated as an equity interest in the trust, that the obligation of the trust to make the payments did not constitute a guaranteed annuity under the GRAT exception in §2702, and that the note should be treated as having a zero value for gift purposes. In addition, the sales agreement in that case conveyed "that number of units having an appraised value of $x million." (The agent also claimed that the FLP was a sham and should be ignored.) The *Karmazin* case was settled later in 2003 on terms very favorable to the taxpayer. Under the settlement, the transaction was not characterized as a transfer of units followed by the reservation of an annuity from the trust, the interest payments paid by the trust were characterized as interest and not as an annuity, neither §§2701 nor 2702 applied, the valuation discount was reduced from 42% to 37%, and the defined value clause in the sales agreement was not given effect.

In *Dallas v. Commissioner*, T.C. Memo. 2006-212, the IRS agent made arguments under §§ 2701 and 2702 in the audit negotiations to disregard a sale to grantor trust transaction by treating the note as retained equity rather than debt, but the IRS dropped that argument before trial and tried the case as a valuation dispute.

Using AFR as Interest Rate for Notes in Intra-Family Sale Transactions

As a practical matter, many intra-family sale transactions use notes having an interest rate equal to the AFR rather than the higher §7520 rate. Sections 1274 and 7872 were enacted soon after the *Dickman* case and address valuing gifts from below market loans. Those sections (which constitute the basis for the AFR) seem to contemplate cash loans, but there is authority that AFRs under §7872 can also be used for sale transactions. *See Frazee v. Commissioner*, 98 T.C. 554, 588 (1992)("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted."); *True v. Commissioner*, T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

Private letter rulings have also taken the position that using an interest rate that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Private Letter Ruling 9535026 involved an installment sale of assets to a grantor

trust in return for a note that paid interest annually at the § 7872 rate (i.e., the AFR), with a balloon payment of principal at the end of 20 years. After summarizing the provisions of § 7872 and the *Frazee* case, the ruling concludes

> "that, if the fair market value of the stock transferred to the [trust] equals the principal amount of the note, the sale of stock to the [trust] will not result in a gift subject to gift tax. This ruling is conditioned on satisfaction of both of the following assumptions: (i) No facts are presented that would indicate that the notes will not be paid according to their terms; and (ii) the [trust's] ability to pay the notes is not otherwise in doubt."

Private Letter Ruling 9408018 addressed whether redemption of a mother's stock by the corporation for a note, where her son was the remaining shareholder, constituted a gift. The note had an interest rate equal to the greater of (i) 120% of the applicable federal mid-term rate, or (ii) the rate sufficient to provide the note with "adequate stated interest" under § 1274(c)(2) (which is tied to the AFR). The ruling employed reasoning similar to Private Letter Ruling 9535026, and concluded that because the interest rate on the note will be at least equal to the AFR for the month during which the note is executed, the fair market value of the note for federal gift tax purposes is the face value of the note. (That ruling similarly was conditioned on (i) there being no indication that the note would not be paid according to its terms and (ii) the corporation's ability to pay the notes is not otherwise in doubt.)

Planning Implications

Careful Planning Required. The *Woelbing* cases are a reminder that sale to grantor trust transactions require careful planning (and there was detailed planning in the sale transaction involved in that case). Planners should be aware (and advise clients) that the IRS is alleging in some cases that the note has a zero value and that the seller makes a gift of the entire value that is transferred. Whether the IRS will prevail is another question altogether, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations.

The planner should pay particular consideration to taking steps to cause the transaction to be treated as a "bona fide transaction" so that the note will be respected as debt rather than being treated as a retained equity interest in the trust. (If the note is treated as an equity interest in the assets that are transferred, the IRS argues that §2702 applies for gift tax purposes and that §§2036 and 2038 apply for estate tax purposes because those Code sections all involve interests retained in the transferred property itself.) Cases have listed a variety of factors that are considered by courts in determining whether intra-family loan or notes transactions are respected. *E.g., Miller v. Commissioner*, T.C. Memo. 1996-3. There are no "safe harbor" regulations for intra-family sale transactions like we have for GRATs.

Defined Value Feature. The defined value feature of the sales agreement may become more common, especially following the *Wandry* case (T.C. Memo. 2012-88). Two prior cases have recognized sale transactions with a defined value element in which "excess value" over a stipulated amount passed to charity. *Petter v. Commissioner*, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Commissioner*, T.C. Memo. 2011-133. The clause in *Woelbing* does not involve an excess amount passing to charity but, like the gift transaction in

Wandry (though the 2006 transaction happened long before the *Wandry* case was decided in 2012), merely defines the amount transferred in terms of a specified value amount. *Woelbing* could be the first Tax Court case addressing the validity of a "Wandry-type" clause in sales transactions.

Another possible "adjustment" approach for sales transactions is to adjust the purchase price based on the finally determined value of the assets that are sold (rather than adjusting the number of units that are transferred). That price-adjustment approach was approved in *King v. United States*, 545 F.2d 700, 703-04 (10th Cir. 1976) but was subsequently rejected in a sale for a private annuity in *Estate of McLendon v. Commissioner*, T.C. Memo. 1993-459, *rev'd*, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause that would adjust purchase price and amount of annuity payments; Tax Court ignored the adjustment clause, based on *Procter* and *Ward*, concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot"). Similarly, a 'price adjustment" clause in a gift transaction was not given effect in *Harwood v. Commissioner*, 82 T.C. 239 (1984), *aff'd without published opinion*, 786 F.2d 1174 (9th Cir. 1986) (gift transfer of limited partnership units with provision that if value finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"; *Procter* and *King* both distinguished; adjustment provision not given effect, based on interpretation of adjustment clause).

Ultimately Just a Valuation Case? Is this primarily just a valuation case? (The IRS contends that the value of the transferred units was $116.8 million compared to the $59 million purchase price). Time will tell whether the IRS settles (as it did in *Karmazin*) or drops the §§2702, 2036 and 2038 arguments (as it did in *Dallas*). If the case proceeds as an attack on whether the note is disregarded for gift tax purposes under §2702 and whether the sold assets are included in the seller's estate under §§2036 and 2038, this case will break new ground and provide court guidance on the requirements for a valid sale to grantor trust transaction.