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Memorandum

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Donor	=
Investment Advisors	=
Company	=
Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Corporation E	=
Trust	=
a	=
b	=
Year 1	=

Year 2	=
Year 3	=
Year 4	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
w	=
x	=
y	=
z	=

ISSUES

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 Whether Donor retained a qualified annuity interest in Trust when Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

CONCLUSIONS

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interest is not a qualified annuity interest under § 2702 of the Internal Revenue Code (Code) because Donor used an outdated appraisal that did not take into account all the facts and circumstances of a pending merger.

FACTS

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.[1] 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.[2] 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.

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[1] This appraisal was prepared by a qualified appraiser as required by § 170(f)(11).
[2] The per share value of $y excluded the value of a spin-off entity created to operate a certain geographic area.

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].”

LAW

Section 2512(a) of the Code provides that if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

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.

Section 25.2512-2(a) generally provides that the value of stocks and bonds is the fair market value per share or bond on the date of the gift.

Section 25.2512-2(b)(1) provides, in relevant part, that if there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market or otherwise, the mean between the highest and lowest quoted selling prices on the date of the gift is the fair market value per share or bond.

Section 25.2512-2(e) provides, in relevant part, that in cases in which it is established that the value per bond or share of any security determined on the basis of the selling or bid and asked prices as provided under § 25.2512-2(b) does not represent the fair market value thereof, then some reasonable modification of the value determined on that basis or other relevant facts and elements of value shall be considered in determining fair market value.

The value of property for Federal transfer tax purposes is a factual inquiry wherein the trier of fact must weigh all relevant evidence and draw appropriate inferences to arrive at the property’s fair market value. Bank One Corp. v. Commissioner, 120 T.C. 174 (2003), rev’d on other grounds, 458 F.3d 564 (7th Cir. 2006) (citing Commissioner v. Scottish Am. Inv. Co., 323 U.S. 119 (1944)). For this purpose, fair market value is the price that a hypothetical willing buyer would pay a hypothetical willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. Treas. Reg. § 25.2512-1; Rev. Rul. 59-60, 1959-1 C.B. 237. The valuation of property is a question of fact. See Estate of Simplot v. Commissioner, 112 T.C. 130 (1999); Redstone v. Commissioner, T.C. Memo. 2015-237.

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.

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).

In Silverman v. Commissioner, T.C. Memo. 1974-285, aff'd, 538 F.2d 927 (2d Cir. 1976), cert. denied, 431 U.S. 938 (1977), the petitioners gifted shares of preferred stock while in the process of reorganizing with the intent to go public. The Tax Court rejected the expert testimony presented by the petitioners because the expert failed to take into account the circumstances of the future public sale.

In Ferguson v. Commissioner, 174 F.3d 997 (9th Cir. 1999), aff'g 108 T.C. 244 (1997), the appellate court considered the issue of whether the Tax Court correctly held that taxpayers were liable for gain in appreciated stock under the anticipatory assignment of income doctrine. In Ferguson, taxpayers owned 18 percent of AHC and served as officers and on the board of directors. In late 1987 and early 1988, the AHC board of directors contacted and eventually authorized Goldman, Sachs & Co. to find a purchaser of AHC and to assist in the negotiations. By July 1988, Goldman, Sachs had found four prospective purchasers. Shortly thereafter, AHC entered into a merger agreement with DCI Holdings, Inc. With the taxpayers abstaining from the vote, the AHC board unanimously approved the merger agreement. On August 3, 1988, the tender offer was started. On August 15, the taxpayers, with the help of their broker, executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1988, the charity and the foundations tendered their stock. On September 12, 1988, the final shares were tendered and on or about October 14, 1988, the merger was completed.

The Court of Appeals 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.

Section 2702(a) provides generally that solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member shall be determined as provided in § 2702(a)(2).

Section 2702(a)(2)(A) provides that the value of any retained interest which is not a qualified interest shall be treated as being zero.

Section 2702(b)(1) provides that a "qualified interest" means any interest which consists of the right to receive fixed amounts payable not less frequently than annually.

Section 25.2702-2(a)(6) defines a "qualified interest" to include a qualified annuity interest and § 25.2702-2(a)(7) defines "qualified annuity interest" as an interest that meets all the requirements of § 25.2702-3(b) and (d).

Section 25.2702-3(b)(1)(i) provides that a qualified annuity interest is an irrevocable right to receive a fixed amount. The annuity amount must be payable to (or for the benefit of) the holder of the annuity interest at least annually.

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.

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 section 664.[3]

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).

Section 25. 2702-3(b)(3) provides, in part, that the annuity may be payable based on either the anniversary date of the creation of the trust or the taxable year of the trust, in annual or more frequent payments.

Section 25.2702-3(b)(5) provides that the governing instrument must prohibit additional contributions to the trust.

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.

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

[3] In 1990, the Senate Budget Committee determined that "the valuation problems inherent in trusts and term interests in property are best addressed by valuing retained interests at zero unless they take an easily valued form-as an annuity or unitrust interest. By doing so, the bill draws upon present law rules valuing split interests in property for purposes of the charitable deduction." Informal Senate Report on S. 3209, 136 CONG. REC. 15629, 15681 (1990). The Senate report further noted that "[t]hese interests are similar to those permitted in charitable split interest trusts under section 664." Id. at n.30.

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.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

[redacted]

[redacted]

Please call (202) 317-4628 if you have any further questions.