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WITH SOPHISTICATED PLANNING, DON'T UNDERESTIMATE THE NEED FOR A PROPER VALUATION

If you are considering a transfer of wealth, then you must consider obtaining a proper valuation to go with it. In the recently issued Chief Counsel Memorandum 202152018 (the "CCA"), the IRS held that a taxpayer's valuation of assets contributed to a grantor retained annuity trust (a "GRAT") was inadequate and, as result, the GRAT failed and the entire contribution was deemed a taxable gift. Although this CCA cannot be cited as legal precedent, it provides a great deal of insight into the position that the IRS would have with respect to funding GRATs and possibly other estate planning vehicles when it comes to valuations.

WHAT IS A GRAT?

A GRAT is a strategy that freezes the value of an asset in your estate and transfers the appreciation of the asset to your beneficiaries. In a typical GRAT, you transfer property to a trust and retain an annuity payment for a fixed term. The value of your GRAT contribution is the value of the property contributed LESS the value of your retained interest via the annuity payments. Generally, the annuity payment is designed to roughly equal the value of the property transferred to the trust, thereby creating a nominal taxable gift (a "zeroed-out" GRAT). At

the end of the term, any appreciation in the transferred property in excess of the annuity payments passes to your children or other family members (called the "remainder beneficiaries") gift-tax free.

A BRIEF OVERVIEW OF CCA 202152018

In the CCA, the taxpayer was the founder of a multi-billion-dollar company. At the end of 2015, the company obtained an appraisal to satisfy the reporting requirements for nonqualified deferred compensation plans under Internal Revenue Code Section 409A. Around this same time, the taxpayer started to market the business for sale. Six months later the business received five offers from different corporations to acquire the company.

Three days after receiving the offers, the taxpayer funded a two-year GRAT with shares of stock in the company. Although it is not known how many shares of stock were gifted to the GRAT, the per share price was based on the 409A appraisal done approximately six months earlier and in the prior year. The taxpayer did not obtain an updated valuation for gift tax purposes at the time the GRAT was created.

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Then, toward the end of 2016, the taxpayer created a charitable remainder trust ("CRT")^[1] and funded it with shares of stock priced three times higher than the per share price used to fund the GRAT. This time, the per share price was determined by a qualified appraisal which was done for charitable deduction purposes.

IRS POSITION

The IRS held that the 409A valuation was not the proper valuation to use for the GRAT transaction. In addition to not being a valuation for gift tax purposes, the 409A valuation was outdated and failed to take into account all of the facts and circumstances existing at the time of the gift (i.e., the pending merger). As a result, the trust failed to qualify as a GRAT, which means the taxpayer was not permitted to reduce the value of the contribution by his retained annuity interest. Therefore, the entire contribution to the GRAT (rather than a nominal value) was deemed to be a taxable gift.

WHAT SHOULD YOU CONSIDER WHEN OBTAINING A VALUATION?

A "qualified appraisal" used to support a gift tax value requires that the appraiser be independent and determine the price at which the 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.^[2]

The report itself must delineate very specific items about the transaction, the asset being valued, and the valuation methodology being used. For instance, when appraising a closely-held business interest, the following facts should be considered:

- The nature of the business and the history of the enterprise from its inception;
- The economic outlook in general and the condition and outlook of the specific industry in particular;
- The book value of the stock and the financial condition of the business;
- The earning capacity of the company;
- The dividend-paying capacity;
- Whether or not the enterprise has goodwill or other intangible value;
- Sales of the stock and the size of the block of stock to be valued; and
- The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

Even if the valuation report sets forth all of the factors and otherwise meets all adequate disclosure regulations for transfer tax purposes, the IRS still has a three-year statute of limitations from the date of disclosure to challenge the valuation.

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¹ A CRT is a tax-exempt irrevocable trust designed to reduce the taxable income of individuals. It dispenses income to one or more non-charitable beneficiaries for a specified period of time and then donates the remainder to one or more charitable beneficiaries. The grantor of a CRT is eligible for an income tax deduction.

² See IRS Revenue Ruling 59-60.

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This publication is a summary of legal principles. Nothing in this article constitutes legal advice, which can only be obtained as a result of a personal consultation with an attorney. The information published here is believed accurate at the time of publication, but is subject to change and does not purport to be a complete statement of all relevant issues.

LESSONS LEARNED

Obtaining an appraisal can be an expensive and sometimes time-consuming process. If you have previously valued a particular asset of yours, you may think that it is unnecessary to have a subsequent appraisal done closer in time to when you wish to make a gift of such asset. One take-away from this CCA is that it is imperative to obtain gift tax appraisals of hard-to-value assets that are dated as closely as possible to the actual asset transfer/gifting date. Any change in circumstances from the date of the appraisal to the date of the transaction should be disclosed to a qualified, professional appraiser so that the appraiser can reflect the facts in the appraisal, if needed. For instance, in the set of facts above, the taxpayer should

not have used the 409A valuation from six months earlier, but should have instead obtained a qualified appraisal that took the pending merger into account and was dated as of the date of the two-year GRAT.

Do not be "penny wise and pound foolish" when it comes to valuations. It is not advisable to save transaction costs by repurposing a valuation already obtained to support the value of a gift. Such a decision may prove to be imprudent, particularly in the wake of this recent CCA. This CCA reminds us that obtaining a timely qualified appraisal is money well-spent, and that disclosing all relevant facts to the appraiser is critical. Please consult with your Wiggin and Dana attorney if you are contemplating gifting assets in the future.