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Settlement of *Woelbing* Cases (Involving Sale to Grantor Trust with Defined Value Feature)

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Sale to Grantor Trust; Valuation Dispute; Defined Value Transfer; IRS Allegation That Sections 2036, 2038 and 2702 Apply to Sale Transaction

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SYNOPSIS

The IRS attacked sale to grantor trust transactions in two companion cases that were filed December 26, 2013 in the Tax Court. *Estate of Donald Woelbing v. Commissioner*, Docket No. 30261-13; *Estate of Marion Woelbing v. Commissioner*, Docket No. 30260-13. Closely held stock was sold to grantor trusts in return for promissory notes from the trusts. The government disputed the valuation of the transferred closely held stock (even though the sales agreement stated that only shares having a value equal to the note amounts were being transferred), and also alleged that §2702 applied (to treat the notes as having a zero value) and that §§2036 and 2038 applied (so that the stock would be included in the seller's estate at its date of death value).

Speculation arose that these cases had settled in March, 2015 on the eve of the first trial setting; if so, apparently that settlement fell through (or they did not resolve everything quickly enough for the judge, and the judge re-set the case to put pressure on the parties to finalize the settlement). On September 29, 2015, the judge set a new trial date of February 29, 2016.

The parties filed a joint status report with the Tax Court on January 12, 2016 indicating that the parties have reached an agreement in principle to settle all issues. The Tax Court entered an Order on January 29, 2016 ordering that the parties submit a stipulated decision document or file a joint report as to the then present status of the case by March 29, 2016.

While the terms of the settlement are unknown, planners have speculated that this case is primarily a valuation dispute, and that the case would be settled without applying §§2702, 2036 and 2038 to the sale to grantor trust transaction.

This pending case has cast some degree of question about sales to grantor trust transactions. The settlement of the case, without the IRS going to the mat on the §§2702, 2036 and 2038 issues (if, indeed, the settlement did not effectively apply those sections), is welcome news.

BASIC FACTS AND ISSUES

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 sales agreement contained a defined value provision stating that shares having a value of $59,004,508.05 were being sold and 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 the trust was obligated eventually to repay Carma for its advances of premium payments.) 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 treated 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 returns for 2006 and several other years were 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 nonvoting 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. (The §2702 argument seems to depend on the same general issue as the §2036 argument, discussed below—was the right to note payments a retained equity interest in the stock that was transferred or was it a separate debt obligation? That may depend on having sufficient cushion in the purchasing trust to support the note as a separate debt obligation and not as necessarily being a retained interest in the transferred stock.) 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. (The $162.2 million value is almost triple the value of the stock used for the sale transaction.) Perhaps the IRS raised the §2068/2038 issue because of a lack of "cushion" in the trust prior to the purchase. Having sufficient net value in the trust to support the purchase and payment of the debt obligation seems to be a critical element in avoiding the application of §2036/2038. *See Fidelity-Philadelphia Trust Co. v. Smith*, 356 U.S. 274 (1958) ("the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made"). Why did the guaranties not provide that "cushion"? It seems that guaranties *should* meet the *Fidelity-Philadelphia* test, but they did not help in *Trombetta v. Commissioner*, T.C. Memo. 2013-234 (strange facts case, including that the grantor retained enjoyment over all the trust assets, not just retained periodic annuity payments).

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). A few other relatively minor valuation issues were involved for other properties in addition to the stock sale transaction.

Pending Settlement

Speculation arose that these cases had settled in March, 2015 on the eve of the first trial setting; if so, apparently that settlement fell through (or they did not resolve everything quickly enough for the judge, and the judge re-set the case to put pressure on the parties to finalize the settlement). On September 29, 2015, the judge set a new trial date of February 29, 2016.

The parties filed a joint status report with the Tax Court on January 12, 2016 indicating that the parties have reached an agreement in principle to settle all issues. The Tax Court entered an Order on January 29, 2016 ordering that the parties submit a stipulated decision or file a joint report as to the then present status of the case by March 29, 2016.

A stipulated decision was entered on March 25, 2016 in the Estate of Donald Woelbing case indicating that no additional gift or estate tax is due. A stipulated decision was entered on March 28, 2016 in the Estate of Marion Woelbing case indicating that no additional gift tax is due, but it does not address estate tax. (The Notice Deficiency to Marion Woelbing addressed only the gift tax and not estate tax; she received that Notice two days before she died in September 2013. The statute of limitations for estate tax is still open on Marion's estate.) Reports from attorneys involved in the case indicate that the IRS recognized the "Wandry-like" provision in the sales agreement (selling that number of shares equal to $59 million), and that §§2702, 2036, and 2038 did not apply because 10% equity existed in the grantor trust that purchased the shares. The result apparently is that more shares were retained by Donald, and passed from his estate to Marion (qualifying for the marital deduction at Donald's death). Therefore, there will likely be more estate tax payable by her estate. The settlement likely included an agreement of the additional shares that were included in Marion's estate, and the date of death valuation of those shares–even though the pending Tax Court cases does not address her estate tax.

Planning Observations

1. **Welcome News**. While the terms of the settlement are unknown, planners have speculated that this case is primarily a valuation dispute, and that the case would be settled without applying §§2702, 2036 and 2038 to the sale to grantor trust transaction.

   This pending case has cast some degree of question about sales to grantor trust transactions. The settlement of the case, without the IRS going to the mat on the §§2702, 2036 and 2038 issues (if, indeed, the settlement does not effectively apply those sections), is welcome news.

   The *Woelbing* facts presented very significant planning issues that could have been addressed by the Tax Court. If the case had not settled, the Tax Court may have been "obliged to address the effectiveness of the value adjustment clause, the substance of the notes, the appropriate interest rate and value for the notes, and the possible reliance on life insurance policies and/or guarantees to provide 'equity' in the trust to support the purchase." Ronald Aucutt, *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax*

Developments of 2015, LEIMBERG ESTATE PLANNING EMAIL NEWSLETTER #2371 (Jan. 4, 2016).

2, **Planning Implications of Settlement**. Many planners have anticipated that this was primarily just a valuation case. (The IRS contended that the value of the transferred units was $116.8 million compared to the $59 million purchase price). The IRS settled (as it did in *Karmazin*, discussed below) apparently dropping the §§2702, 2036 and 2038 arguments (it dropped a §2702 argument before trial in *Dallas*). If the case had proceeded as an attack on whether the note was disregarded for gift tax purposes under §2702 and whether the sold assets were included in the seller's estate under §§2036 and 2038, this case would have broken new ground and provided court guidance on the requirements for a valid sale to grantor trust transaction.

Many planners are continuing to use sales to grantor trusts with explanations to clients as described above, and the fact that the IRS did not treat these allegations as "go to the mat" issues in the *Woelbing* cases is welcome news.

Highly respected commentators from McGuireWoods have offered their view of the planning implications of the case (in a summary available on the McGuireWoods website authored by Ron Aucutt, Birch Douglass, William Sanderson, Dennis Belcher, and Skip Fox):

> In any event, as merely a settlement, the stipulated decision has no precedential value, even if we knew exactly what substantive trade-offs informed the outcome. The settlement, while very good for the parties, deprives the estate planning community of an opportunity to learn how the Tax Court might really decide difficult issues affecting the common estate planning technique of installment sales to grantor trusts, including relatively new issues like the possible reliance on life insurance policies and beneficiaries' guarantees to provide "equity" in the trust, the application of section 2702 to the sale, and the application of sections 2036 and 2038 after the sale, and even including the seemingly familiar yet still disputed issue of the use of defined value clauses.
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> …
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> It is impossible to overlook or downplay, and difficult to explain or excuse, what appears to have been a very aggressive approach on the part of the IRS. The total amount of gift tax, estate tax, and penalties at issue for both estates was $152 million, over 250% of the appraised value of the transferred stock at the time of the transaction and even almost 94% of what the IRS asserted to be the much higher date-of-death value of the stock. While there may be some double-counting in those numbers, the all-too-familiar drumbeat of valuation, section 2702, section 2036, section 2038, and "accuracy-related" penalties suggests a degree of overreaching that itself could be subject to penalties if employed by a taxpayer. We have noted this "everything-but-the-kitchen-sink" approach in the Woelbing cases before, as in the Comment on Development Number Three in the **"Top Ten" Estate Planning and Estate Tax Developments of 2014**. *Id.*

The McGuireWoods analysis also observes that perhaps the use of value imbedded in a split dollar life insurance policy and beneficiary guarantees to support the sale transaction, reinforced by an aggressive form of defined value clause, may have resulted in the failure to keep a low profile with the IRS. It also observes that the Woelbing cases involve an ongoing business (that produces Carmex lip balm), and the IRS may not have been as willing to settle had the case involved a family limited partnership holding marketable securities.

In conclusion of the planning implications of the *Woelbing* settlement, the McGuireWoods analysis points out the importance of planners balancing the features of the sale structuring with the resulting risks:

> The lesson is that levels of foreseeable risk, reward, complexity, delay, and expense need to be explained, understood, and balanced in a way that matches the client's tolerances and minimizes the possibility of surprises. Often this balancing will forgo the use of every imaginable feature, even features that appear to be in common use, in favor of greater predictability and peace of mind and, yes, staying out of the Tax Court and out of alerts like this. *Id.*

3. ***Estate of Beyer.*** John Porter (tax litigator from Houston, Texas) reports that he tried another case in December 2013 (*Estate of Beyer v. Commissioner*, trial judge is Judge Chiechi) in which the IRS also made the §2036 argument; the IRS argued that all of the assets of a family limited partnership are included in the estate under §2036 and it also argued that partnership interests that were sold to a grantor trust should also be brought back into the estate under §2036. That case was tried over two years ago and is still awaiting decision.

4. **Gift Tax Arguments Similar to Those in *Karmazin***. 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 examiner 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.

5. **Careful Planning Required**. The *Woelbing* cases are a reminder that sale to grantor trust transactions require careful planning (and detailed planning occurred in the sale transaction involved in that situation). Planners should be aware (and may wish to advise clients) that the IRS has alleged in some cases (1) that the note has a zero value and that the seller makes a gift of the entire value that is transferred, and (2) that the assets sold to the grantor trust should be brought back into the seller's gross estate for estate tax purposes. Whether the IRS would prevail in a court test is another question altogether, particularly if the grantor trust has significant equity value prior to the sale, but sales transactions with grantor trusts are clearly sophisticated transactions requiring careful detailed planning considerations. Many planners are continuing to use sales to grantor trusts with explanations to clients as described above, and the fact that the IRS did not treat these allegations as "go to the mat" issues in the *Woelbing* cases is welcome news.

6. **Bona Fide Transaction**. 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. (As an analogy, debt/equity principles are applied under §385 in the context of shareholder loans.) No "safe harbor" regulations exist for intra-family sale transactions, in contrast to the objective rules that apply for GRATs.

7. **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 (*Petter* and *Hendrix*) have recognized sale transactions with a defined value element in which "excess value" over a stipulated amount passed to charity. 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 have been the first Tax Court case addressing the validity of a "*Wandry*-type" clause in sales transactions. (*King*, *McLendon*, and *Harwood* addressed the validity of "price adjustment" clauses in sales transactions.) It is no secret that the IRS is very unhappy with the *Wandry* result, and the fact that the IRS recognized the *Wandry* transfer in the settlement is rather surprising:

> But this is a surprising settlement, substantively and procedurally. It is especially surprising that the IRS would effectively agree to the defined value clause, which IRS personnel are known to really dislike. The only plausible explanation may be that the IRS attorneys thought their position on the valuation issue itself was very weak, and the executors' attorneys thought so too, and this was the only way the IRS was able to credibly seek any concession on value. McGuireWoods Legal Insights Alert, *Parties Settle Closely Watched Tax Court Cases Involving Defined Value Clause*, (April 1, 2016).

8. **Danger of Gift Splitting With Potential §2036 Issue**. This case illustrates the danger of making the gift splitting election when the possibility exists that §2036 (or one of the other "string" statutes) may apply to the transfer. If the IRS is successful in its position that §2036 applies to the sale (part gift, under the IRS's position) transaction, all of the transferred stock will be included in Mr. Woelbing's estate, and §2001(b)(last sentence) provides that the gift element in his transfer will not be included as an adjusted taxable gift in his estate. However, no similar provision applies to "undo" the taxable gift of one-half of the gift element by Mrs. Woelbing.

   In effect, all of the transferred asset is included in Mr. Woelbing's estate (at its date of death value) and one-half of the date of gift value is treated as a gift by Mrs. Woelbing.