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CCA 201939002 – Anticipated Merger Must Be Considered in Valuing Stock

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CCA 201939002 Leaves Important Questions About the Relevance in Valuation Cases of Information Not Reasonably Available to Hypothetical Buyers

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Synopsis

IRS Chief Counsel Advice (CCA) 201939002, dated May 28, 2019, and released September 27, 2019, concluded that a stock on a listed exchange had to be valued for gift tax purposes by taking into consideration an anticipated merger of the underlying company that was expected to increase the value of the stock. The co-founder and Chairman of the Board of Corporation A, a publicly-traded corporation, transferred shares of stock of the corporation to a GRAT on "Date 1." Apparently extensive merger discussions had transpired before that date. The merger agreement apparently was based on a certain value being attributed to the shares of Corporation A, substantially greater than the value at which the shares were trading. Later, on "Date 2," the merger with Corporation B was announced, which resulted in the value of the Corporation A stock increasing substantially, though less than the agreed merger price.

Prior to Date 1, when the gift was made, "negotiations with multiple parties" had ensued and eventually "exclusive negotiations with Corporation B" occurred. Not stated in the CCA is whether the merger negotiations had proceeded to the point of having an agreed, or at least strongly anticipated, merger price being attributed to the shares of Corporation A on Date 1 when the gift was made.

The issue is whether the shares should be valued under Reg. § 25.2512-2(b)(1) at the mean between the highest and lowest quoted selling prices on the date of the gift, or by taking into consideration the anticipated merger. Reg. § 25.2512-2(e) states that if the value determined from the mean between the high and the low selling prices does not represent the fair market value of the shares, then some reasonable modification of the value shall be considered in determining fair market value.

Fair market value for transfer tax purposes 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. Reg. § 25.2512-1. The CCA reasoned that the presumption of having "reasonable knowledge of relevant facts" applies even if the relevant facts were unknown to the actual owner of the property (citing *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 123 AFTR 2d 2019-2296 (9th Cir. June 21, 2019). Both parties are presumed to have made a reasonable investigation of the relevant facts, *id.*, and reasonable knowledge includes facts that a reasonable buyer or seller would uncover during the course of negotiations, even though not publicly available (the hypothetical willing buyer is presumed "to have asked the hypothetical willing seller for information that is not publicly available"). *Id.*

The CCA repeats the oft-stated general rule that post-transfer events may be considered only to the extent they are relevant to the value on the transfer date. *E.g. Estate of Noble v. Commissioner*, T.C. Memo. 2005-2.

The CCA cites two cases for authority that the value should be determined after taking into consideration the anticipated merger. *Silverman v. Commission*er, T.C. Memo. 1974-285, *aff'd*, 538 F.2d 927 (2d Cir. 1976), *cert denied*, 431 U.S. 938 (1977) (gift of shares of preferred stock while in the process of reorganizing with the intent to go public; court rejected expert testimony that failed to consider the circumstances of the anticipated future public sale); *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g,* 108 T.C. 244 (1997) (taxpayer was an officer and director of a corporation of which the board of directors had approved a merger agreement; after the merger was "practically certain to go through" but before the actual merger occurred, the taxpayer gave shares to charities; when the charities sold the shares, the taxpayer realized the gain under the assignment of income doctrine). While *Ferguson* was an anticipatory assignment of income case rather than a gift tax valuation case, the CCA pointed to the many factual similarities with *Ferguson* (a target search to find merger candidates, exclusive negotiations before the final agreement, generous terms of the merger, and an agreement that was "practically certain" to go through) in relying on it for the proposition that "the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through." The CCA concluded:

> Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger would undermine the basic tenets of fair market value and yield a baseless valuation.

Important Questions Left Open

The CCA fails to even mention one critical fact. The donor was the Chairman of the Board of the publicly traded corporation, and federal securities laws may have prohibited the donor from disclosing confidential information regarding the merger to a purchaser. The CCA does repeat a statement from various cases that "[t]he 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 [citing *Estate of McCord* and *Estate of Newhouse*]," and that they are both "presumed to be dedicated to achieving the maximum economic advantage [citing *Estate of Newhouse*]." The CCA does not discuss this statement in light of the personal characteristics of the actual donor (as Chairman of the Board, subject to securities law limitations on disclosure of information about the publicly-held company), and the cited cases do not turn on any specific characteristics of the donor.

What if the merger discussions were highly secret and not even rumors of the discussions were available, so that no one who was not prohibited from disclosing the information knew about the discussions? The donor would know that the "mean between the high and the low" value was not appropriate, but no hypothetical third party could know that even with the exercise of reasonable diligence. A hypothetical purchaser who was dealing with a hypothetical seller who knew about the information but could not disclose it would not be able to find out about the information even if the buyer made diligent and persistent inquiries. An answer to this theoretical dichotomy may be that a hypothetical **SELLER** with this knowledge would never sell at a price well below the anticipated merger price, even though that information could not be disclosed to a hypothetical buyer. Therefore, the donor's knowledge of the information, even though it could not be disclosed, would still have to be taken into account in determining the fair market value.

Nevertheless, the CCA concludes categorically that "as of Date 1 [the date the GRAT was funded], the hypothetical willing buyer of the stock could have reasonably foreseen the merger and anticipated that the price of Corporation A stock would trade at a premium" and that "the hypothetical willing buyer …, as of Date 1, would be reasonably informed during the course of negotiations over the purchase and sale of Shares and would have knowledge of all relevant facts, including the pending merger." Although that may have been true on the full facts the IRS was considering, such confidence is not explained in the CCA itself. Under applicable case law, the CCA correctly views the willing buyer and willing seller in the valuation standard of Reg. § 25.2512-1 as "hypothetical." The regulation deems those hypothetical parties to have "reasonable knowledge of relevant facts," and the anticipated merger certainly seems to be "relevant" to the value of the shares. The question under the regulation is whether knowledge of the merger would be "reasonable" in the case of secrecy imposed by law or agreement. The CCA assumes that such knowledge would be "reasonable" without discussion and without even acknowledging the question.

It should also be noted that under this analysis a donor might be able to make a gift KNOWING that the reported gift tax value will substantially understate the real value because of insider information known by the donor. (At the other end of the spectrum, in addition to asserting an anticipatory assignment of income as in *Ferguson*, the IRS might be able to argue for a much smaller charitable deduction than the realistic full value of the stock.) That may be another reason that the conclusion of the CCA is entirely appropriate, but, again, without explanation or acknowledgment.

Moreover, even if the anticipated merger were taken into consideration, that would not necessarily mean that the anticipated merger price would be the fair market value at the time the GRAT was funded. There may have been some possibility that the merger would fall through, and even if the merger were consummated, the extent to which the merger actually impacted the value of stock after the merger was announced would be uncertain. Indeed, the CCA acknowledges that "after the merger was announced, the value of the Corporation A stock increased substantially, though *less than the agreed merger price*" (emphasis added). But the anticipated merger would still be considered as a factor in determining the fair market value of the stock.

One lesson from CCA 201939002 is that every word of a regulation can matter. If advice is received from the National Office of the IRS during the audit of a valuation issue, care must be taken to confirm that every assumption underlying the advice – whether explicit or implicit – is appropriate, and that a case against the taxpayer's position is not overstated, even inadvertently. As stated above, the conclusion of CCA 201939002 might be entirely appropriate on the full facts of the case, but vigilance and scrutiny would be needed to confirm that.

If the case for which this CCA was issued proceeds to trial, no doubt these facts will be fully explored by the court, and the court's discussion of the legal test of what is meant by "reasonable knowledge of relevant facts" in valuation cases may be quite interesting.