BESSEMER TRUST

Elcan v. Commissioner, Tax Court Docket No. 3405-25 (Petition filed March 14, 2025)

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GRAT Examination Involving Substitution Transactions for Grantor Notes; IRS Is Surprisingly Taking the Position That Using Grantor Notes to Satisfy Annuity Payments Causes the Entire Value Contributed to the GRAT to Be a Taxable Gift

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1. Brief Synopsis

The grantor (husband and wife made the split gift election so they were both treated as donors) created GRATs and subsequently exercised substitution powers various times to obtain cash from the GRATs and at other times to re-acquire general partnership interests and S corporation stock that had been contributed to the GRATs. Notes from the grantor received by the GRATs in the substitution transactions were subsequently distributed to the grantor to satisfy required annuity payments. (The final annuity payment could not be fully satisfied with the remaining assets in the GRAT.) The IRS issued deficiency notices to each spouse for $306,929,994 gift tax and $61,385,999 penalties, for total deficiencies of over $736 million.

The notices of deficiency stated that the initial gifts to the GRATs were taxable gifts in their entirety because the grantor's retained annuity interests were not qualified interests under §2702. Alternatively, if the retained interests are determined to be qualified interests, the transfers of the grantor's notes to the GRATs in substitution transactions in which the grantor re-acquired partnership interests and stock that had been contributed to the GRATs were taxable gifts. The notices did not state why the retained interests were not qualified interests under §2702 or why the notes given to the GRATs in the substitution transactions were taxable gifts. Twenty percent accuracy-related penalties were assessed under §6662 because the underpayment was due to negligence or disregard of the rules and regulations.

The IRS's Answer was filed July 9, 2025; it gives no further insight as to the rationale for the gift conclusions in the deficiency notices. *Elcan v. Commissioner*, Tax Court Docket No. 3405-25 (Petition filed March 14, 2025).

2. Basic Facts

- GRAT I and GRAT II were created on Feb. 20, 2018 and May 22, 2018, respectively. Shares of a Delaware S corporation (Frisco), an investment holding company, and units of a general partnership (Hercules), an investment holding company, were transferred to the GRATs. The values of the interests in Frisco and Hercules transferred to the GRATs collectively were $687,503,860. The GRATs provided for two annual annuity payments, described as specified percentages of the values transferred to the GRATs. The annuity payments from GRATs I and II totaled $721,624,342.13.
- The values of the Frisco shares transferred to the GRATs were valued by appraisal and the values of the Hercules units were determined based on the average of the high and low trading prices of the publicly held stock owned by Hercules on the transfer dates. (The same valuation method was used to determine all transfers to and from the GRATs and from GRAT III, described below.)
- The grantor substituted a note for $1.27 million from GRAT II on July 13, 2018, and substituted notes in the collective amount of $852,742,730.49 for the interests in Frisco and Hercules that had been transferred to each of GRAT I and GRAT II on August 15, 2018.
- All the notes used in the transfections with the GRATs bore a commercial interest rate (Prime + 1%).
- The substitution of notes for the units and stock in GRATs I and II had the effect of leaving a net of $852,742,730.49 - $721,624,342.13, or $131,118,388.36, plus interest on the notes, that would remain at the termination of the GRATs to pass to the GRAT remaindermen without further gift taxes.
- Shares of Frisco (slightly more than the number contributed to GRATs I and II) and units of Hercules (same number as contributed to GRATs I and II) were contributed to GRAT III on August 15, 2018.
- Substitution powers were exercised to substitute notes (Prime + 1%) for cash transfers from GRAT III (in amounts ranging from about $1.2 million to almost $1.5 million) on October 15, 2018, Jan. 10, 2019, April 10, 2019, and July 6, 2019. (Observe that some of those were close to the grantor's income tax estimated payments dates.)
- On May 12, 2020, the grantor exercised her substitution power (1) to acquire all of the Frisco shares and some of the Hercules units from GRAT III in return for a $360,303,240.73 note and (2) to acquire additional units of Hercules in return for a $200,000 note.

- The first annuity payment, due on August 20, 2019, was satisfied by transferring some of the grantor's notes and some of the Hercules units to the grantor. The second annuity payment, due on August 15, 2020, was satisfied in part by transferring all the remaining assets of GRAT III to the grantor (some notes and units of Hercules). The entire second annuity payment could not be satisfied fully, and no remainder was left in GRAT III to pass to remainder beneficiaries.
- The grantor filed a 2018 gift tax return that made the split-gift election.
- The IRS mailed notices of deficiency on December 18, 2024, to the grantor and her husband, and they filed a Petition with the Tax Court on March 14, 2025. The IRS filed its Answer on July 9, 2025; the Answer provided no further explanation of the IRS's positions.

3. Notices of Deficiency and IRS Rationale For Its Position

a. **Notices of Deficiency.** On December 18, 2024, notices of deficiency were mailed to grantor and her husband reporting gift tax deficiencies by the grantor and her husband in the aggregate amount of $613,859,989 and under-valuation penalties of $122,771,998, for total deficiencies of $736,631,987.

b. **IRS Rationale for Deficiencies.** The notices of deficiencies gave very little reasons for the determination of the tax deficiencies. They gave two summary reasons: (1) the transfers to the GRATs I, II, and III was not made in returns for qualified interests under §2702 (without any explanation of why they were not qualified interests); and (2) alternatively, that the transfers of the grantor's notes to the GRATs in substitution transactions in which the grantor re-acquired interests in Frisco and Hercules that had been contributed to the GRATs were taxable gifts.

Twenty percent accuracy-related penalties were assessed under §6662 because the underpayment was due to negligence or disregard of the rules and regulations.

4. Taxpayers' Motion for Partial Summary Judgment.

The taxpayers filed a motion for partial summary judgment on October 1, 2025. The motion described in detail the relevant facts of the funding and operation of the three GRATs (including the exercises of substitution power and the uses of grantor-notes to satisfy annuity amounts). The motion makes three major points in response to the contention in the Notice of Deficiency that the annuity interests were not "qualified interests" under §2702:

(i) the annuities were "qualified interests" under the unambiguous provisions of § 2702(b)(1);

(ii) given the unambiguous definition of a "qualified interest" under § 2702(b), the additional "qualified interest" requirements imposed by Treas. Reg. § 25.2702-3 are (i) irrelevant to determining whether Trisha's retained annuity interests were "qualified interests," and (ii) invalid under Loper Bright and related case law; and

(iii) the GRATs satisfied the "qualified interest" requirements of Treas. Reg. § 25.2702-3.

a. **Annuities Constituted "Qualified Interests."** Section 2702(b) describes three different ways an interest can meet the definition of a qualified interest. The first is an interest that is a fixed right to receive fixed amounts payable no less frequently than annually. The IRS conceded the GRATs satisfied that requirement, so "no further analysis is required."

b. **Additional Regulatory "Qualified Interest" Requirements Are Irrelevant and Invalid under *Loper Bright*.**

(1) **Regulations Cannot Override Unambiguous Statute.** Even under the *Chevron* analysis that applied prior to *Loper Bright*, "where the statute is unambiguous and the intent of Congress is clear, the statute must control the legal analysis. Various statements from the Tax Court n *Varian Medical Systems & Subsidiaries v. Commissioner*, 163 T.C. 76 (2024), reiterate that regulatory provisions can override clear statutory provisions, quoting several Supreme Court cases: "self-serving regulations never 'justify departing from the statute's clear text'"; "w]here . . . the provisions of the act are unambiguous, and its directions specific, there is no power to amend it by regulation"; and "Respondent's regulation . . . cannot change the result dictated by an unambiguous statute."

[**Observation:** The opening line of a very recent Eighth Circuit Court of Appeals case very concisely emphasizes this important principle: **"Statutes trump regulations."** *3M Company, and Subsidiaries v. Commissioner*, Circuit Ct. No. 23-3772 (Oct. 1, 2025) (emphasis added).]

(2) **The Regulations Are Interpretive Regulations That Erroneously Interpreted §2702 and Under *Loper Bright,* Are an Impermissible Interpretation of §2702 And Are Invalid.** There is no statutory authority for regulations to implement §2702 (unlike in §2704), but the §2702 regulations are interpretive regulations issued under the general authority of §7805(a). They are valid only if they are the "best reading" of the statute. The additional requirements in the GRAT regulations are an impermissible interpretation of §2702 and the regulations are invalid because (i) they are inconsistent with the plain text of §2702(b), (ii) the requirements in Reg. §25.2702-3 are inconsistent with §2702(b), and (iii) those requirements are inconsistent with the legislative history and purpose of §2702(b) (which were to prevent the annuity from being overvalued when the trust is funded and to assure the annuitant actually receives assets with a value not less than the amount to which she was entitled to receive under the trust instrument). Reg. §25.2702-3(b)(1) and (d)(6), which prohibit a GRAT from issuing its note in satisfaction of annuity amounts, are entitled to even less deference under the Supreme Court "change in position" doctrine because they were not adopted until eight years after the initial GRAT final regulations were issued.

In addition, the regulatory requirements in Reg. §25.2702-3 are inconsistent with §2512, which says that gifts are valued on the date of their transfer. Events that postdated the funding of the GRATs (such as the reacquisition of assets using substitution powers and the GRATs' satisfaction of annuity amounts with notes they acquired from the grantor) cannot be used to determine the values of gifts under §2512. Furthermore, those events are not inconsistent with the regulations, which only require that the trust agreement prohibit certain events, and the trust agreements contained all of those restrictions.

The Tax Court has previously invalidated regulations that impermissibly disregard Congress's direction. *E.g. Walton v. Commissioner*, 115 T. C. 589, 595 (2000).

c. **GRATs Satisfy the "Qualified Interest" Requirements of Reg. §25.2702-3.** The distribution of the grantor's notes in satisfaction of annuity amounts did not violate Reg. §25.2702-3(b)(1) and (d)(6), which prohibit a GRAT from issue its note in satisfaction of annuity amounts. "No notes were issued by any of the trusts to satisfy Trisha's retained annuity interests under Treas. Reg. §25.2702-3(b)(1)."

5. Planning Considerations

a. **Two Recurring GRAT Examination Issues.** The IRS appears to be examining a number of GRAT transactions, involving both (1) valuations of assets contributed to GRATs and (2) substitutions for notes with grantor-notes. One observer (not a party in the case) has described *Elcan* as "part of the IRS's crusade." Other planners have noted that the IRS has made and is making these arguments in various pending IRS examinations.

b. **GRAT Valuation Examinations.** The *Elcan* examination does not involve questioning the value of the assets contributed to the GRATs (the Answer filed by the IRS in *Elcan* agreed to the values reported for the contributions to the GRATs). However, there have been various examinations of GRATs involving valuations, and the IRS sometimes takes a position similar to its position in CCA 202152018 that treated a GRAT annuity as not being a qualified interest because of the undervalued appraisal used to determine the annuity amounts that were paid by the GRAT over its two-year term. Accordingly, the donor was treated as making a gift equal to the full finally determined value of the shares transferred to the GRAT, without any offset for the value of the donor's retained annuity payments.

The CCA analogized to *Atkinson v. Commissioner*, 115 T.C. 26 (2000), *aff'd*, 309 F.3d 1290 (11th Cir. 2002), which denied an income tax charitable deduction for the creation of a charitable remainder annuity trust because of the manner in which the trust was operated (no annuity payments were actually made), even though the agreement itself met the technical requirements for CRATs.

CCA 202152018 reasoned that the result was appropriate because of the donor's "deliberately using an undervalued appraisal." Perhaps the IRS concern in this CCA was not so much with the appraised *amount* but with the *process.* The donor appeared to have used a valuation that the donor knew was seven months out of date, prepared for another purpose, and which substantially undervalued the shares because of intervening events (obviously unknown to the appraiser). The case underlying that CCA is currently in litigation.

Similarly, the CCA reasoned that basing the annuity payments on an undervalued appraisal was an "operational failure" that resulted in Donor not having retained a qualified annuity interest under §2702.

c. **GRAT Examinations Regarding Substitutions and Grantor Notes.** Substitutions for notes and using the grantor's notes to satisfy annuity payments have also been a target of various gift tax examinations (including *Elcan*). If notes are substituted for GRAT assets using inflated values of GRAT assets, the IRS would certainly be expected to treat the excess value as an additional gift (which would be a prohibited additional contribution to the GRAT and which might result in the contribution being treated as held by the trustee as a constructive trustee for the grantor). However, when GRAT assets are valued appropriately (and in this case they were based on appraisal of the Frisco stock and on the basis of the actual values of publicly traded stock held by Hercules), the substitution transaction is merely an investment decision (the trustee must determine that it is receiving "an equivalent value").

   (1) **Does Not Violate Regulation.** Using grantor notes held by the GRAT to satisfy annuity payments does *not* violate the prohibition in regulations prohibiting a GRAT from "issuing a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity or unitrust payment obligation." Reg. §25.2702-3(d)(6). *See also* Reg. §25.2702-3(b)(1)(i) ("Issuance of a note, other debt instrument, option, or other similar financial arrangement, directly or indirectly, in satisfaction of the annuity amount does not constitute payment of the annuity amount"). In *Elcan*, none of the three GRATs "issued a note" in satisfaction of annuity payments. Instead, the GRAT used some of its assets (notes payable to it) to satisfy the annuity payments.

   (2) **Commentator Support.** The taxpayer's Petition quotes an article by Carlyn McCaffrey for support of the position that using notes from another party (including the grantor) to satisfy annuity payments does not violate the prohibition in the regulations from the GRAT issuing its own note to satisfy annuity payments. The petition quotes the article as follows.

> The prohibition against the "issuance" of a note or similar financial arrangement does not prevent the use of notes issued by other persons to satisfy the payment obligation. *For example, a note issued by the grantor's spouse, by another trust, or even by the grantor would not violate this prohibition. The trustees of the GRAT might acquire such a note by selling some or all of the GRAT's assets to the issuer of the note*. See e.g., C. McCaffrey, "The Care and Feeding of GRATs – Enhancing GRAT Performance Through Careful Structuring, Investing and Mentoring." (emphasis added in the petition).

   (3) ***Loper Bright* Challenge.** Furthermore, the regulation itself might be attacked on *Loper Bright* grounds as not being the "best reading" of the statute.

d. **IRS Facing Political Challenges to Its "Aggressive and Novel Positions" in GRAT Audits and Litigation.** Written questions have been submitted to Donald Korb in proceedings in the Senate Finance Committee regarding his confirmation of IRS Chief Counsel. Some of those questions have expressly addressed positions that the IRS has been taking in audits and litigation involving GRATs. Senator Cornyn (R-TX) asked:

Legislative proposals which would curtail GRATs have been introduced but never passed into law. The IRS under the last Administration instead pursued audits and litigation to impose requirements and standards not written in the statute or Treasury regulations.

Do you agree the IRS must follow Treasury's regulations consistent with statute and not use audits or litigation to impose novel tax theories, including in cases regarding GRATs?

Answer: I believe that staff at both the Treasury and IRS must follow the law as written. Further, the IRS should not place unnecessary regulatory burdens on any taxpayers through audit or litigation. If confirmed, I look forward to working with you on this matter.

Senator Daines (R-MT) asked:

I have heard from constituents that during the Biden administration, the IRS took aggressive and novel positions challenging the use of grantor retained annuity trusts ("GRATs") driven by staff's political ideologies. It is my understanding that these positions are contrary to both the clear wording of section 2702, the statute by which GRATs are sanctioned, and the interpretive regulations issued by the Treasury Department under that statute.

If confirmed, will you and your staff commit to enforcing the tax code by applying the laws as written by Congress?

If confirmed, will you and your staff commit to reviewing from a fresh perspective those pending matters where the IRS is challenging the use of GRATs, to ensure that the IRS personnel in charge are correctly applying I.R.C. § 2702 and its regulations as those provisions were written and not imposing their own views on what the law should be?

Answer: I believe that staff at both the Treasury and IRS must follow the law as written. If confirmed, I will instruct all my staff to do just that.

United States Committee on Finance, Hearing to Consider the Nominations of Jonathan Greenstein, to be a Deputy Under Secretary of the Treasury, and Donald Korb, to be Chief Counsel of the Internal Revenue Service and an Assistant General Counsel in the Department of the Treasury (Sept. 10, 2025).

The IRS may be facing some political pressure regarding its "aggressive and novel positions" regarding GRATs, and the Trump administration, with urging from Republican Senators, may direct a change in the IRS's position regarding some of its positions about GRATs. It is interesting that GRATs have come to the attention of Senators, who are of the view that the IRS is taking aggressive and novel positions to impose their own views on what the law should be and that the new IRS Chief Counsel should review "from a fresh perspective those pending matters where the IRS is challenging the use of GRATs."

e. **Common Situations Involving GRAT Substitutions for Grantor Notes.** Substitution transactions to acquire GRAT assets in return for a promissory note from the grantor are used routinely in various situations including (1) to obtain cash from the GRAT for the grantor to make estimated income tax payments, (2) to insulate a successful GRAT from later losses, or (3) to reacquire depreciated assets from a "losing" GRAT to re-GRAT them and hope the assets will appreciate from their depreciated values. In *Elca*n, it appears that all three reasons may have been applicable.

f. **Planning Alternative – Pay Grantor's Note Before Annuity Payment Date.** A possible alternative to avoid the IRS's argument is for the grantor to transfer assets to the GRAT before the annuity payment date to pay off the note, and the GRAT could distribute those assets back to the grantor on the annuity payment date. Another approach is for the grantor to borrow funds from a bank to pay off the note shortly before the annuity payment is due; the cash could be used to make the upcoming annuity payment and the grantor could use the cash to pay back the bank loan.

g. **What Interest Rate Should be Used in GRAT Substitutions?** What interest rate should be used in substitution transactions with GRATs? The notes must represent "equivalent value" for the assets acquired from the GRAT. In *Elcan*, the parties used a commercial rate (prime + 1%). Arguably, an interest rate equal to the AFR could be used because for gift tax purposes, a transfer in return for an AFR note is not a gift under §7872. Using too high an interest rate could be abusive (it would shift additional value to the GRAT), and the IRS could argue that it would result in an additional

contribution to the GRAT, which is prohibited under the regulations. In the event the values transferred to the GRAT in the substitution transaction are determined to be excessive, the taxpayer could take the position (or the trust agreement might explicitly provide) that the excess value is held by the trustee as a constructive trustee for the benefit of the person who made the excess value transfer. (The taxpayers made that argument in *Elcan* in case the IRS should determine that the notes used an excessive interest rate.)

h. **Future Planning.** Should taxpayers use substitution transactions with GRATs in return for notes from the grantor in the future? The position being taken by the IRS is not supported by the regulations. Some reputable firms are still advising grantors that substitution transactions in return for grantor notes do not violate the regulations but are advising them of the surprising position being taken by the IRS.