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ESTATE & SUCCESSION PLANNING CORNER—*Woelbing* Wobbles and It Actually May Fall Down: Will Grantor Trust Sales Find Themselves on the Endangered Species List?

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Since 1990, two sophisticated techniques often used to transfer discounted assets, and appreciating assets, during life are: grantor retained annuity trusts (GRATs), statutorily authorized under Code Sec. 2702, and sales to grantor trusts ("Sales"), the validity of which is pieced together using Chapter 12's willing-seller/willing-buyer test and transfers for adequate consideration as an exception to gifts and the Code Secs. 671–677 rules on grantor trusts.

In past columns, we have compared GRATs versus Sales[1] and why one technique may be better than the other under certain circumstances. Overall, Sales are easier to administer, slightly more powerful, potentially GST-exempt and more flexible. However, they also do not have the clear statutory authority of GRATs.

Up until the last couple of years, however, Sales rarely were challenged by the IRS. Two recent high-profile cases, *Estate of Davidson*,[2] and *Estates of Woelbing*,[3] involving sales were unagreed at the IRS level, and both found themselves filing petitions in Tax Court.

The two *Estate of Woelbing*[4] cases are still at the Tax Court level, and it is this case, and fact pattern, that should provide practitioners with a caution sign in determining to use Sales over GRATs. One conservative heuristic to follow: to the extent a client fact pattern can be dealt with effectively by GRATs, GRATs become the more conservative option. If properly structured, they are beyond IRS reproach.

As Robert Frost emphasized, when the tax practitioner reaches the fork in the planning road, take the GRAT path, and let the Sales one become overgrown with practitioner worry.

The *Woelbing* Fact Pattern in a Nutshell

The *Donald Woelbing* case provides a fairly clear battle line. Using what appears to be a *Wandry*-defined value clause, Mr. Woelbing sold nonvoting stock in his closely held business in exchange for an interest-bearing promissory note in the amount of $59,004,508. The IRS argued that the value of the stock sold was $116,840,286. In addition to arguing that Code Sec. 2702 applied to the transaction (*i.e.,* the GRAT rules), and the note was not a qualified interest, making the transaction a gift of $116,840,286, the IRS also argued that Code Sec. 2036 required inclusion of the trust in the decedent's gross estate.

If nothing else, that kind of notice of deficiency will cause a few sleepless nights to the planners.

The Equities Are Troubling

When read with an erudite and precise lens, the fact pattern and protective structures in the case should withstand challenge; the planning strategy should be upheld. From the pleadings, it appears that many (not all) "i's" were dotted and "t's" crossed. The trust had over 10 percent in value of other assets to satisfy the note (*hmmmm* … but where was the down payment?). Guarantees (to the tune of perhaps an additional 10 percent) were provided by the beneficiaries. The sales contract had a "defined value"

clause, *à la J.M. Wandry*.[5] Moreover, a reputable valuation was obtained indicating the fair market value of the property sold.

But life is not that easy for tax practitioners. In the Tax Court, there could appear a scent of fairness, equity and Congressional intent. From a business perspective, the seller would not enter into this transaction.

Over the years, I have written extensively on the sham-transaction doctrine as applied to estate tax strategies: economic purpose (long before it was used by the Tax Court to invalidate partnerships under Code Sec. 2036), step transactions and form over substance. I have also argued that the sham-transaction doctrine—an income tax principle—has no place in the estate tax world. After all, certain estate, gift and generation-skipping statutes, which are Congressionally blessed, create strategies that truly have no substance, that are step transactions, and that have no business purposes: Qualified Personal Residence Trusts (QPRTs), GRATs, credit shelter trusts and the annual exclusion, to name four.

But when the Tax Court does not like the scent of a creative, and perhaps permissible, planning transaction, it does not hesitate to pull out these principles to invalidate it.

For example, the Tax Court trotted out "economic substance" as a concept to invoke Code Sec. 2036 and invalidate discount planning in the partnership setting. That concept has been going on so long that practitioners are now accepting it as a real doctrine. Nevertheless, it is quite the stretch to apply "economic substance" to create that Code Sec. 2036 infraction—it probably does not truly make sense.

The Referee Blows the Whistle—An Infraction with Sales?

Sales are the first cousin, once removed, to GRATs. They essentially take a statutorily allowed gift and estate tax technique—Code Sec. 2702 as applied to GRATs—and expand what is allowed by the statute to create more flexibility for a similar transaction.

To emphasize, I would assert that Sales are permissible and statutorily allowed through various provisions of the Code. However, I do want to point out what the Tax Court could consider and rule. Applying the sham-transaction principles, the Tax Court could hold that Sales are an impermissible expansion of what is allowed through GRATs. Essentially, the court, if it gets that far in *Woelbing*, could hold that Sales are transactions that do not qualify for GRAT treatment because they do not meet the statutory requirements and hence are full gifts.

Removing the Patina

GRATs are an expression of Congressional intent. What is not allowed to qualify for a GRAT is also an expression of Congressional intent. For example, GRATs are not allowed to be generation skipping. GRATs cannot vary in the payment schedule—they must be a fixed annuity amount. GRATs must use a Code Sec. 7520 rate, not a lower applicable federal rate (AFR) (the short- or mid-term rate).

With a Sale, these are structured to be GST-exempt; often, the payments are interest only with permissible prepayments, and the interest rate is tied to the AFR for the term of the loan (often either the mid-term rate for loans less than nine years or the long-term rate for longer-term loans).

The Tax Court could reason that the Sale is no more than a perversion of the rules allowed by GRATs and could construct a reason why the transaction falls within Code Sec. 2702,[6] which would be fatal for the

strategy. If the Sales transaction is within Code Sec. 2702, it would result in a full gift of the transferred property, as the note would not qualify for valuation.

Recommendations

The practitioner is left with three roads, not the two that Robert Frost indicates are in front of us.

First, and the one I have advocated for the last 15 years, is to consider whether the planning goals can be achieved by GRATs. GRATs are not generation skipping, and to make them generation skipping runs afoul of the same Congressional concern as Sales,[7] but GRATs can be substantially estate tax effective.

Second, if GRATs cannot be used, *e.g.,* cash flow in the trust will only allow interest payments for a short period of time, consider bolstering the integrity of the Sales approach. Is there an old-and-cold, and well-funded, grantor trust that can be used as the purchaser in the Sales transaction?

Third, if Sales are to be used, they meet all Code requirements. These are favored strategies and have been used since 1976 without adverse tax consequences. The transaction is not one that historically, or currently, is likely to be subject to an audit. Audits are still far and few on these strategies.

Forecasting the Future

In *Woelbing,* the assessed tax deficiencies (and penalties) are too substantial. The taxpayer cannot easily risk a bad holding. Conversely, despite the vast tax treasure buried at the end of the deficiency rainbow, the IRS may not want to risk blessing the strategy. The case should be settled, in which event Treasury likely will then come out with either proposed regulations or perhaps a Notice, trying to end the Sales transaction. Like the Passenger Pigeon, the Sales approach may be in the process of being poached to oblivion by its overuse.

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[1] Louis S. Harrison, Estate & Succession Planning Corner, *The Ties that Bind: Administering the Trust*, J. PASSTHROUGH ENTITIES, Mar.–Apr. 2015, at 13.

[2] *Estate of Davidson*, Tax Court Cause No. 013748 (filed June 14, 2013, but now settled).

[3] *Estates of Woelbing,* Tax Court Docket Numbers 30261-13 and 30260-13.

[4] This column will refer to only the *Estate of Donald Woelbing*. There is a companion case, *Estate of Marion Woelbing*, sharing many of the same issues and concerns.

[5] *J.M. Wandry*, 103 TCM 1472, Dec. 59,000(M), TC Memo. 2012-88.

[6] After all, they used "economic substance" to artificially push the discounted partnership into the Code Sec. 2036 regime; the Tax Court can be very creative in its application of estate and gift tax statutes.

[7] Practitioners have advocated selling the remainder interest, essentially valued at zero, during the term of the GRAT. That seems to be contrary to Congressional intent under the rules of Code Sec. 2702.