Pioneer Bank & Trust

Trust & Investments

Local.

704 7th Ave, PO Box 729
Belle Fourche, SD 57717-0729
Phone (605) 892-3494
Fax (605) 892-2115

2001 W Omaha St, PO Box 9189
Rapid City, SD 57709-9189
Phone (605) 341-2265
Fax (605) 341-7425

140 E Jackson Blvd, PO Box 10
Spearfish, SD 57783-0010
Phone (605) 642-2725
Fax (605) 642-1736

PLANNING THOUGHTS

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Defined value clauses and sales to grantor trusts

Estate planners have been watching the *Woebling* cases because they included two somewhat aggressive estate planning strategies: use of a defined value formula gift to limit gift tax exposure, and the sale of stock to a grantor trust in exchange for a promissory note. Unfortunately, the resolution of the cases earlier this year will not add to our understanding of these strategies.

Background

The Woebling family owned Carma Laboratories, Inc., a successful maker of skin care products. In 2006 Donald Woebling had the company valued by an independent appraiser. Based upon the appraisal, Donald sold his 1,092,271.53 shares of nonvoting stock in Carma Labs to an irrevocable trust for $59,004,508.05. The Installment Sale Agreement further provided that "in the event that the value of a share of stock is determined to be higher or lower than that set forth in the Appraisal, whether by the Internal Revenue Service or a court, then the $59,004,508.05 purchase price shall remain the same but the number of shares of stock purchased shall automatically adjust so that the fair market value of the stock purchased equals $59,004,508.05."

This defined value clause was intended to short-circuit any finding that the transaction included a taxable gift. Defined value clauses have been upheld in several cases, most notably *Wandry v. Comm'r* [T.C. Memo 2012-88]. See also *Petter v. Commissioner*, [T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011)] and *Hendrix v. Commissioner*, [T.C. Memo. 2011-133], in which the excess value passed to charity, rather than having an adjustment to the number of shares transferred.

Donald died in 2009, three years after the estate-freezing transaction. The IRS selected his estate tax return for audit. On September 27, 2013, the IRS sent an estate and gift tax deficiency notice for $32 million. Two days later, Donald's wife, Marion, died.

The IRS position

The IRS valued the promissory note at zero, which meant that the entire value of the transfer of the stock to the trust in 2006 was a gift. What's more, the IRS valued those shares at $117 million, nearly double what the independent appraiser had found for the value. Although valued at zero, the Service treated the note as a "retained interest," causing the entire value of the stock to be fully included in Donald's taxable estate. By the time that he died, the IRS believed that Carma Labs had grown in value to over $162 million.

A gift tax deficiency also was assessed against Marion's estate, as she and Donald had split their gifts in 2008. The total estate and gift tax deficiencies for both estates came to over $125 million, and penalties came to another $25 million. In other words, the estates owed the government nearly the entire value (as determined by the government) of Carma Labs itself!

Resolution and a takeaway

The estates filed their Tax Court petitions at the end of 2013. After protracted negotiations, earlier this year the IRS and the estates reached a settlement. The deficiencies were cancelled, and a stipulated judgment was entered [https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=6813993 and https://www.ustaxcourt.gov/UstcDockInq/DocumentViewer.aspx?IndexID=6812800].

Apparently, the estates conceded a higher value for the stocks, and the IRS conceded that the defined value clause worked as intended, so that fewer shares of stock passed to the trust. The shares that did not so pass would instead pass outright to Marion, and they would be protected from the estate tax by the marital deduction. The settlement included the stipulation that no adjustment was needed in Donald's estate tax, so apparently the IRS conceded that the date-of-death value of the shares was not included in his estate.

However, an estate tax will be due on those "excess" shares that passed to Marion at Donald's death. The amount of that tax was not included in the stipulated judgment.

All in all, this would seem to be a pro-taxpayer outcome. The amount potentially owed to the IRS was reduced from about $150 million to zero. On the other hand, the heirs have had to deal with considerable uncertainty, delay, and substantial attorney fees to reach this goal. We don't know what impact this litigation had on the operations of Carma Labs itself. Donald probably did not realize that his carefully crafted estate plan, assembled by qualified professionals, would lead to this result. Would he have chosen a different approach had he known?

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