Walton v. Commissioner, 115 T.C. 589 (2000)

A grantor retained annuity trust (GRAT) with a fixed-term annuity payable to the grantor or the grantor's estate qualifies for valuation as a qualified interest under Section 2702, and Treasury Regulation Example 5, which suggests otherwise, is invalid.

Summary

Audrey Walton established two grantor retained annuity trusts (GRATs), each funded with Wal-Mart stock, with a two-year term and annuity payments to herself, or her estate if she died during the term, with the remainder to her daughters. Walton valued the gift to her daughters at zero, arguing her retained interest was the full value of the stock. The IRS argued that only the annuity payable during Walton's life was a qualified interest, relying on Treasury Regulation Example 5, which limits the qualified interest to the shorter of the term or the grantor's life. The Tax Court held that a fixed-term annuity payable to the grantor or estate is a qualified interest for the full term, invalidating Example 5 and siding with Walton's valuation method.

Facts

Prior to April 7, 1993, Audrey Walton owned shares of Wal-Mart stock.

On April 7, 1993, Walton created two substantially identical GRATs, each funded with Wal-Mart stock.

Each GRAT had a two-year term.

Walton was to receive annuity payments from each GRAT, a fixed percentage of the initial trust value, payable annually.

If Walton died during the term, the annuity payments were to be made to her estate.

Upon completion of the term, the remaining balance was to be distributed to her daughters, Ann Walton Kroenke and Nancy Walton Laurie, as remainder beneficiaries.

The trust instruments were irrevocable and prohibited payments to anyone other than Walton or her estate during the term.

Walton, as grantor, and each daughter, as beneficiary, served as co-trustees for their respective GRAT.

The annuity payments were made as scheduled, exhausting the GRAT assets by June 1995, leaving nothing for the remainder beneficiaries.

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Walton valued the gifts to her daughters at zero on her gift tax return.

Procedural History

The IRS issued a notice of deficiency, arguing Walton understated the gift value.

Walton conceded a gift value of $6,195.10 per GRAT, while the IRS asserted a value of $3,821,522.12 per GRAT.

The case was submitted to the Tax Court fully stipulated.

Issue(s)

Whether, for purposes of valuing gifts under Section 2702, a fixed-term annuity payable to the grantor or, if the grantor dies within the term, to the grantor's estate, qualifies as a "qualified interest" for the entire term.

Whether Treasury Regulation § 25.2702-3(e), Example 5, which suggests that such an annuity is qualified only for the shorter of the term or the grantor's life, is a valid interpretation of Section 2702.

Holding

1. Yes, a fixed-term annuity payable to the grantor or the grantor's estate is a "qualified interest" for the entire term because Section 2702 and its legislative history support valuing such annuities as qualified interests for the full specified term.

2. No, Treasury Regulation § 25.2702-3(e), Example 5 is not a valid interpretation of Section 2702 because it unreasonably restricts the definition of a qualified interest and is inconsistent with the statute's purpose and legislative history.

Court's Reasoning

The court reasoned that Section 2702 aims to prevent undervaluation of gifts by valuing retained interests at zero unless they are "qualified interests," such as annuity interests. The legislative history indicates that fixed-term annuities are intended to be treated as qualified interests.

The court found that Walton retained the annuity interests, either individually or through her estate, as one cannot make a gift to oneself or one's estate.

The court criticized Treasury Regulation Example 5, which limits the qualified interest to the shorter of the term or the grantor's life, as an unreasonable interpretation of Section 2702.

The court stated, "With respect to the text itself, the short answer is that an annuity for a specified term of years is consistent with the section 2702(b) definition of a

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qualified interest; a contingent reversion is not."

The court emphasized that Congress intended to allow fixed-term annuities as qualified interests and that making payments to the grantor's estate in case of death during the term is consistent with this intent.

The court also drew an analogy to charitable remainder annuity trusts under Section 664, where term annuities payable to an individual or their estate are valued as fixed-term interests, finding it inconsistent for the IRS to treat GRAT annuities differently.

The court concluded that Example 5 was an invalid extension of Section 2702 and held that Walton's GRAT annuities qualified as retained interests for the full two-year term.

Practical Implications

This case clarifies that for GRATs, a fixed annuity term can extend beyond the grantor's life without disqualifying the retained interest for valuation purposes under Section 2702.

It allows estate planners to structure GRATs with terms of years, ensuring the full annuity value is subtracted from the gift, even if payments continue to the grantor's estate.

This decision limits the IRS's ability to rely on Treasury Regulation Example 5 to undervalue retained annuity interests in GRATs.

Later cases and IRS rulings must consider the Tax Court's rejection of Example 5 when valuing GRATs with fixed terms payable to the grantor or estate.

Practitioners can confidently structure GRATs with fixed terms, knowing the annuity interest will be valued for the entire term, regardless of the grantor's lifespan, enhancing the effectiveness of GRATs for wealth transfer.

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