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

A retained annuity interest in a GRAT payable to the grantor or the grantor's estate for a specified term of years is valued as a qualified interest under section 2702.

Summary

Audrey Walton established two grantor retained annuity trusts (GRATs) with Wal-Mart stock, retaining the right to receive an annuity for two years, with any remaining payments due to her estate upon her death. The IRS challenged the valuation of the gifts to her daughters, arguing that the estate's contingent interest should be valued at zero. The Tax Court held that the retained interest, payable to Walton or her estate, was a qualified interest under section 2702, to be valued as a two-year term annuity. This decision invalidated a regulation that would have treated the estate's interest separately, emphasizing that the legislative intent of section 2702 was to prevent undervaluation of gifts, not to penalize properly structured GRATs.

Facts

Audrey Walton transferred over 7 million shares of Wal-Mart stock into two substantially identical GRATs on April 7, 1993. Each GRAT had a two-year term, and Walton retained the right to receive an annuity equal to 49. 35% of the initial trust value for the first year and 59. 22% for the second year. If Walton died before the term ended, the remaining annuity payments were to be paid to her estate. The trusts were funded with 3,611,739 shares each, valued at $100,000,023. 56. Walton's daughters were named as the remainder beneficiaries. The trusts were exhausted by annuity payments made to Walton, resulting in no property being distributed to the remainder beneficiaries.

Procedural History

Walton filed a gift tax return for 1993, valuing the gifts to her daughters at zero. The IRS issued a notice of deficiency, asserting that Walton had understated the value of the gifts. Walton petitioned the Tax Court, which held that the retained interest was to be valued as a two-year term annuity, not as an annuity for the shorter of a term certain or Walton's life.

Issue(s)

1. Whether Walton's retained interest in each GRAT, payable to her or her estate for a two-year term, is a qualified interest under section 2702, to be valued as a term annuity?
2. Whether the regulation in section 25. 2702-3(e), Example (5), Gift Tax Regs. , is a valid interpretation of section 2702?

Holding

1. Yes, because the retained interest is a qualified interest under section 2702, as it is payable for a specified term of years to Walton or her estate, consistent with the statute's purpose of preventing undervaluation of gifts.
2. No, because the regulation is an unreasonable interpretation of section 2702, as it conflicts with the statute's text and purpose, and is inconsistent with other regulations and legislative history.

Court's Reasoning

The court applied the statutory text of section 2702, which defines a qualified interest as an annuity payable for a specified term of years. The court rejected the IRS's argument that the estate's interest should be treated as a separate, contingent interest, citing the historical unity between an individual and their estate. The court found that the legislative history of section 2702 aimed to prevent undervaluation of gifts, not to penalize properly structured GRATs. The court also noted that the IRS's position was inconsistent with the valuation of similar interests under section 664 for charitable remainder trusts. The court invalidated the regulation in section 25. 2702-3(e), Example (5), as an unreasonable interpretation of the statute, emphasizing that the retained interest should be valued as a two-year term annuity.

Practical Implications

This decision clarifies that a retained annuity interest in a GRAT, payable to the grantor or the grantor's estate for a specified term, is a qualified interest under section 2702. This allows grantors to structure GRATs without fear that the IRS will treat the estate's interest as a separate, non-qualified interest. The decision may encourage the use of GRATs as an estate planning tool, as it validates a common structure for such trusts. Practitioners should note that this case invalidated a specific regulation, and future IRS guidance may attempt to address this issue. Subsequent cases, such as Cook v. Commissioner, have distinguished this ruling, emphasizing the importance of properly structuring GRATs to avoid undervaluation of gifts.

