Estate of Christiansen v. Commissioner

Formula Disclaimer That Operates Much Like a "Defined Value Transfer Clause" Does Not Violate Public Policy

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Steve R. Akers
Bessemer Trust
300 Crescent Court, Suite 800
Dallas, Texas 75201
214-981-9407
akers@bessemer.com

Introduction

The Tax Court reviewed the validity of a formula disclaimer, that operated much in the same manner as defined values clauses, in Estate of Christiansen v. Commissioner, 130 T.C. No. 1 (2008). The court unanimously approved the formula disclaimer to a foundation and rejected the IRS's arguments that the clause violated public policy (and much of the court's reasoning would also apply to defined value clauses — the court did not rely on the fact that formula disclaimers are specifically authorized by the regulations in its public policy discussion). (While all of the judges in this full Tax Court opinion agreed as to the validity of the formula disclaimer for assets passing to the foundation, the opinion itself says that Judge Halpern did not participate in the opinion, and Judges Chiechi, Gale, and Laro did not join in any of the majority, concurring or dissenting opinions.)

The case is especially important because of its implications for defined value transfers, in which a transfer is made and allocated between a "taxable" and "non-taxable" portion based on gift or estate tax values. A redetermination of value by the IRS operates much like with a standard marital deduction formula clause, where an increased value allocates a larger value to the surviving spouse but does not generate additional estate tax. A major uncertainty has been whether courts will uphold inter vivos defined value transfers against a public policy attack (even though standard marital deduction formula clauses in wills have operated in that same manner for decades). This case may become a bellwether case in leading the way to upholding defined value transfers despite attacks by the IRS on public policy grounds.

1. Formula Disclaimer With Assets Passing to CLAT and Foundation

The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a charitable lead annuity trust and 25% to a foundation. (The charitable lead trust paid an annuity to charity for 20 years equal to 7% of the initial value of the trust. Apparently the annuity amount and term were designed so that the present value of the charitable lead interest was equal or almost equal to the full value passing to the trust.) The daughter made a formula disclaimer, in effect disclaiming a fractional share of the estate exceeding $6.35 million, and the estate tax return reflected an estate value of $6.51 million. The specific formula disclaimer clause provided, in part, as follows:

> "Intending to disclaim a fractional portion of the Gift, Christine Christiansen Hamilton, hereby disclaims that portion of the Gift determined by reference to a fraction, the numerator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, less Six Million Three Hundred Fifty

> Thousand and No/100 dollars ($6,350,000) and the denominator of which is the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001…."

The clause went on to define "fair market value" by reference to "as such value is finally determined for federal estate tax purposes."

In addition, the disclaimer included a "savings clause" which provided that to

> "the extent that the disclaimer set forth above in this instrument is not effective to make it a qualified disclaimer, Christine Christiansen Hamilton hereby takes such actions to the extent necessary to make the disclaimer set forth above a qualified disclaimer within the meaning of section 2518 of the Code."

Under the values as returned, about $120,000 passed to the CLAT and about $40,000 passed to the foundation as a result of the disclaimer. (As mentioned below, the IRS agreed that it would allow a charitable deduction for the $40,000 that passed to the foundation as a result of the disclaimer — based on the values reported on the estate tax return.)

In the estate tax audit, the IRS and the estate agreed to increase the fair market value of the gross estate from approximately $6.5 to $9.6 million. (The estate included farm and ranching businesses that had been transferred to family limited partnerships. The estate claimed a 35% discount for the limited partnership interests, which seems reasonable, so there must have disputes about the underlying values of the businesses.) Under the disclaimer, the additional $3.1 (i.e., $9.6 – 3.5) million value all passed to the CLAT and foundation, and if those transfers qualified for the estate tax charitable deduction, there would be *no additional estate tax*. (In this manner, the formula disclaimer operated much like "defined value" transfer clauses designed to define the amount transferred so that there would be no (or minimal) additional gift tax over the intended amount.) The IRS agreed that it would allow an estate tax charitable deduction for the $40,000 that passed to the foundation based on the values reported on the Form 706, but it refused to allow any charitable deduction for the remaining increased value of the estate that passed to charity as a result of the disclaimer.

2. Effectiveness of Disclaimer to CLAT

The majority held that the disclaimer was not a qualified disclaimer as to the 75% potion that passed to the CLAT, because the disclaimed property did not meet the requirement in §2518(b)(4)(B) of passing "to any person other than the person making the disclaimer." (Accordingly, no estate tax charitable deduction was available for the

75% that passed to the CLAT.) The majority reasoned that the daughter retained her contingent remainder interest, which was not "severable property" or "an undivided portion of… property." Therefore, no portion of the disclaimer to the CLAT was a qualified disclaimer.

Regulation §25.2518-2(e)(3) includes the following statement:

> "If the portion of the disclaimed interest in property which the disclaimant has a right to receive is not severable property or an undivided portion of the property, then the disclaimer is not a qualified disclaimer with respect to any portion of the property. Thus, for example, if a disclaimant who is not a surviving spouse receives a specific bequest of a fee simple interest in property and as a result of the disclaimer of the entire interest, the property passes to a trust in which the disclaimant has a remainder interest, then the disclaimer will not be a qualified disclaimer unless the remainder interest in the property is also disclaimed."

The example in that regulation seems to apply specifically to a CLAT remainder, but the example is prefaced with the prior sentence saying that the section applies if the disclaimed property is not severable property or an undivided portion of property.

The terms "severable property" and "undivided portion of the property" are described in Regulation §25.2518-3(a)(1)(ii) and 25.2518-3(b), respectively. The "undivided portion" regulation includes the following statement:

"A disclaimer of some specific rights while retaining other rights with respect to an interest in the property is not a qualified disclaimer of an undivided portion of the disclaimant's interest in property. Thus, for example, a disclaimer made by the devisee of a fee simple interest in Blackacre is not a qualified disclaimer if the disclaimer disclaims a remainder interest in Blackacre, but retains a life estate."

The majority reasoned that the contingent remainder interest fell within this example, with a wonderful analogy to a piece of meringue pie [if there's anything I understand, it is coconut meringue pie!]:

> "Disclaiming a vertical slice — from meringue to crust — qualifies; disclaiming a horizontal slice — taking all the meringue, but leaving the crust — does not."

(Two dissenting judges disagreed, reasoning in part that a disclaimant can make a qualified disclaimer of income if the decedent herself carved out income or corpus interest in her will, and a disclaimant is not trying to do so through the disclaimer. They argue that the *decedent* created the CLAT that received the disclaimed interest, and that the disclaimant did not create the charitable lead interest and the remainder interest. In addition, they argue that the disclaimant's remainder interest and the foundation's lead annuity interest in the CLAT are complete and independent of each other and therefore meet the

definition of severable property. The charity has the right to receive specified fixed annuity payments over the 20 year term of the trust, and — unlike an income interest — does not vary based on what happens to the rest of the trust. A concurring opinion responds that the annuity and remainder are even more dependent on each other than an income and remainder interest, because some of the annuity interest might have to be paid from principal, which would reduce the value of the remainder.)

[Observation: I do not know of any cases that have previously addressed specifically whether disclaimed assets can pass to a CLAT in which the disclaimant has a remainder interest. In PLR 9501036, the IRS ruled that a disclaimer, which resulted in assets passing to a CLAT, was a qualified disclaimer where the disclaimant also disclaimed the remainder interest in the CLAT. The ruling did not specifically say that the additional disclaimer of the remainder interest was essential to the validity of the disclaimer to the CLAT. Also of interest is PLR 9610005, which ruled that a unitrust interest in a CRUT is separate from a disclaimed principal interest, even though unitrust payments would be made from principal if income was insufficient.]

Effect of Disclaimer Savings Clause

The majority also concluded that the disclaimer "savings clause" did not save the day. The majority said it did not have to determine whether this kind of savings clause violates public policy. It reasoned that if the savings clause operates once the court enters a decision, the resulting disclaimer will have been made more than nine months after the decedent's death. If the savings clause is "read as somehow meaning" that she disclaimed the contingent reminder back when she signed the disclaimer,

> "it fails for not identifying the property being disclaimed and not doing so unqualifiedly, see sec. 2518(b), because its effect depends on our decision. Such contingent clauses — contingent because they depend for their effectiveness on a condition subsequent — are as ineffective as disclaimers as they are for revocable spousal interests [citing Focardi] and gift adjustment agreements [citing Ward]."

That language in the majority agreement casts doubt on savings clauses that are interpreted as depending upon a condition subsequent and particularly on disclaimer savings clauses.

3. Effectiveness of Formula Disclaimer to Foundation

The 25% of the disclaimed assets that passed directly to the foundation had no problem satisfying the "pass to someone other than the disclaimant" requirement. The Commissioner challenged the formula disclaimer to the foundation for two reasons: (1) any increasing amount passing to the foundation was contingent on a condition subsequent; and (2) the disclaimer's adjustment phrase (based on "value [as] finally determined for federal estate tax purposes") is void as contrary to public policy.

a. Condition Subsequent

The IRS pointed to regulation §20.2055-2(b)(1) which disallows a charitable deduction if

> "as of the date of legacy to his death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective…"

The court concluded that regulation does not apply because the regulation refers to "a transfer" of property passing to charity, and the *transfer* to the foundation in this case occurred at the time of the disclaimer and is not contingent on any event that occurred after the decedent's death. "That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent…"

b. Public Policy Concerns

The most interesting aspect of the opinion is its analysis of the public policy concerns. The court said it was hard pressed to find any fundamental public policy against making gifts to charity. Nevertheless, the Commissioner cited the Procter case, which addressed a clause specifying that a gift would be deemed to revert to the donor or if it were held to be subject to gift tax. The Fourth Circuit in Procter voided the clause as contrary to public opinion, citing three reasons: (1) the provision would discourage collection of tax, (2) it would render the court's own decision moot by undoing the gift being analyzed, and (3) it would upset the final judgment. As to reasons (2) and (3), the court's reasoning seems to apply to defined value clauses generally:

> "This case is not Procter. The contested phrase would not undo a transfer, but only reallocate the value of the property transfer among Hamilton, the Trust, and the Foundation. If the fair market value of the estate assets is increased for tax purposes, the property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case."

Observe that the court's rationale applies word for word to defined value transfers where, for example, property is transferred to a trustee and the defined value clause operates to allocate the property between two separate trusts under the trust agreement.

As to the reference in Procter about reducing the incentive of the IRS to audit returns as a result of the disclaimer clause, the court acknowledged that the IRS's incentive "will marginally decrease," but observed that lurking behind the Commissioner's argument is the intimation that this type of arrangement will increase the possibility that an estate will lowball the reported value of the estate to cheat charities. However, the majority reasoned that IRS estate tax audits are far from the only policing mechanism, pointing to the fiduciary duties of executors and directors of foundations, the possible involvement of state attorneys general and even the Commissioner himself if fiduciaries misappropriate charitable assets (by threatening to rescind the charity's tax exemption or by its power to impose intermediate sanctions).

The court's reasoning does not seem to address directly the "discourage collection of tax" argument, and seems overly simplistic in stating that the arrangement will only "marginally decrease" the IRS's incentive to audit returns. (There are a wide variety of planning strategies that can reduce the IRS's incentive to audit returns — such as the common formula marital deduction clause in a will, and a broader discussion of this public policy concern would have been more helpful.) However, every Tax Court judge participating in the opinion either joined in the majority or concurred in the public policy aspect of the decision. (As mentioned above, Judges Chiechi, Gale, and Laro did not join in any of the opinions, and Judge Halpern did not participate in the case.)

The court's reasoning, which emphasizes outside policing mechanisms, applies where the "pourover" transfer is to charity, but does not apply as strongly where the pourover is to a family entity. The trustee fiduciary duties would be present, but the references to fiduciary duties of directors of a foundation, to state attorneys general, and to the Commissioner (in overseeing charitable entities) would not apply.

The Tax Court unanimously upheld on public policy grounds formula disclaimers that operate much like defined value transfers, without saying in that analysis that it was relying to any degree on the fact that formula disclaimers are specifically authorized by regulations. This might suggest that the Tax Court would rule similarly when faced with whether defined value transfer clauses violate public policy. It is interesting that in McCord, the Tax

Court seemed to stretch to find a way of avoiding having to address the public policy effect of a defined value clause, but the Tax Court in Christiansen unanimously found no public policy concerns with a similar approach using a formula disclaimer (at least where the disclaimed assets passed to charity).

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