Estate of Christiansen v. Commissioner, 104 AFTR2d 2009-XXXX (8th Cir. Nov. 13, 2009, corrected Nov. 18, 2009)

Eighth Circuit Upholds Formula Disclaimer Over Public Policy Objections (or "Friday the 13th Massacre of IRS Position on Defined Value Clauses")

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

Synopsis

In a "Friday the 13th" decision, the Eighth Circuit Federal Court of Appeals dealt a crushing blow to the IRS's position of refusing to recognize "defined value" types of clauses. In Estate of Christiansen, a sole beneficiary disclaimed all of the estate (under a fractional formula) in excess of $6,350,000. The disclaimed assets passed 75% to a charitable lead annuity trust ("CLAT") and 25% to a foundation. The IRS and the estate agreed to increase the value of the gross estate from $6.5 to $9.6 million. The Tax Court held that the disclaimer as to the 75% that passed to the CLAT did not satisfy all the technical disclaimer requirements (so the estate owed estate tax on that portion of the increase value of the estate). The estate did not appeal that aspect of the case. As to the 25% that passed to the foundation, the technical disclaimer problem did not exist, and the IRS argued that a charitable deduction should not be permitted for the increased value for two reasons. First, any increased amount passing to the charity was contingent on future events in violation of a charitable deduction regulation. Second (and more importantly in the broader planning context), the transfer violates public policy because it reduces the IRS's incentive to audit estate tax values. The Eighth Circuit rejected both of the IRS's arguments. Many of the reasons for rejecting the public policy reasons apply generally to certain types of defined value clauses.

The case is especially important because of its implications for defined value transfers, such as (1) a transfer that is made and allocated between a "taxable" and "non-taxable" portion based on gift or estate tax values or based on agreement of the parties, or (2) a transfer in which the amount transferred is defined by a formula referring to gift or estate tax values. A redetermination of value by the IRS operates much like under 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 appears to be a bellwether case in leading the way to upholding defined value transfers despite attacks by the IRS on public policy grounds.

Basic Facts

The decedent's will left her entire estate to her daughter. Any disclaimed assets would pass 75% to a CLAT and 25% to a foundation. (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 slightly over $6.5 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."

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. 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. 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.

The Tax Court held that the disclaimer to the CLAT was not a qualified disclaimer due to technical violations of the disclaimer regulations, so no estate tax charitable deduction was allowed for amounts passing to the CLAT under the disclaimer. The estate did not appeal that finding. The Tax Court held that the disclaimer to the foundation did not have any of the technical disclaimer problems and that the disclaimer was not contingent on a subsequent event and did not violate public policy; an estate tax charitable deduction was allowed for the full increased gross estate amount that passed to the foundation under the disclaimer. The IRS appealed that determination.

Holding

The formula disclaimer was recognized and all of the increased value that passed to the foundation qualified for the estate tax charitable deduction. The Tax Court decision was affirmed. (The corrected decision merely made a minor one-word change.)

Analysis

1. Contingent on Subsequent Event Argument Rejected. Treasury Regulation §20.2055-2(b)(1) provides that an estate tax charitable deduction is not available if the charitable transfer is "dependent upon the performance of some act or the happening of a precedent event." The IRS argued that the amount passing to the charity was contingent on the determination of the final estate tax value.

    a. Tax Court. The Tax 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 in the sense of dependent for its existence on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future."

    b. Eighth Circuit. The regulation requires the existence of "*a transfer at the date of death;*" not "the existence or finality of an accounting evaluation." The only outstanding issue was valuation, and "[t]he foundation's right to receive twenty-five percent of those amounts in excess of $6.35 million was certain." There is a difference between post-death events that change the actual value of an asset and events that "are merely part of the legal or accounting process of determining value at the time of death." Cases cited by the IRS all involved situations where the actual transfer was dependent on various contingencies (such as a daughter dying without descendents, and a trust that allowed the family beneficiary to invade corpus).

Furthermore, estate tax charitable deduction regulations regarding charitable lead annuity trusts recognize that references to values "as finally determined for Federal estate tax purposes" are sufficiently certain to be considered "determinable" to qualify as a guaranteed annuity interest. Treas. Reg. §20.2055-2(e)(2)(vi)(a). Therefore, references to values "as finally determined for estate tax purposes" are not references that are dependent upon post-death contingencies that might disqualify the availability of a charitable deduction.

2. Public Policy Argument Rejected.

   a. IRS Position. "[T]he Commissioner argues that we should disallow fractional disclaimers that have a practical effect of disclaiming all amounts above a fixed-dollar amount. According to the Commissioner, such disclaimers fail to preserve a financial incentive for the Commissioner to audit an estate's return. With such a disclaimer, any post-challenge adjustment to the value of an estate could consist entirely of an increased charitable donation. Because this scenario would provide no possibility of enhanced tax receipts as an incentive for the Commissioner to audit the return and ensure accurate valuation of the estate, the Commissioner argues such disclaimers should be categorically disqualified as against public policy."

   b. Recognition of "Marginally" Decreased Incentive. The Eighth Circuit agreed that the disclaimer of all amounts in excess of a fixed-dollar amount "may marginally detract from the incentive to audit estate tax returns." In some situations, that might permit "a charitable deduction equal to the increase in the estate, resulting in no increased estate tax." (However, footnote 2 observed that under the facts of this case, there is no offsetting charitable deduction for the 75% of the increased value that passed to the CLAT.) The IRS's argument is that strategies such as a fixed-dollar amount partial disclaimer that operate to allow an additional deduction to offset any increased value should be disallowed on policy grounds "because of the potential moral hazard or untoward incentive they create for executors and administrators to undervalue estates."

      The court gave three reasons, discussed immediately below, for rejecting the IRS's public policy argument even if the effect is that increasing values in audits would not increase the estate tax collected as a result of the audits.

   c. IRS's Role Is to Enforce Tax Laws, Not Just Maximize Tax Receipts. "First, we note that the Commissioner's role is not merely to maximize tax receipts and conduct litigation based on a calculus as to which cases will result in the greatest collection. Rather, the Commissioner's role is to enforce the tax laws." **[Observe: This reason applies just as strongly to all defined value clauses.]**

   d. No Clear Congressional Intent of a Policy to Maximize Incentive to Audit. "Second, we find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for the Commissioner to challenge or audit returns. The relevant policy in the present context is clear, and it is a policy more general in nature than that articulated by the Commissioner: Congress sought to encourage charitable donations by allowing deductions for such donations." **[Observe: This reason only applies to "formula allocation clauses" (described in Item 1 of the "Observations" section below) that "pourover" the excess over a defined value amount to a charity.]**

   e. Other Mechanisms Exist to Ensure Values Are Accurately Reported. "The Commissioner premises his policy argument on the assumption that executors and administrators will

purposefully undervalue assets in order to take advantage of his marginally decreased incentive to audit. In the present context, however, there are countless other mechanisms in place to ensure that fiduciaries such as executors and administrators accurately report estate values. State laws impose personal liability on fiduciaries, and state and federal laws impose financial liability or, in some circumstances criminal sanctions, upon false statements, fraud, and knowing misrepresentations." (The court cites statutes and cases providing that the personal representative is a fiduciary and that the attorney general has a duty to enforce the rights of charitable foundations). Furthermore, "the contingent beneficiaries taking the disclaimed property have an interest in ensuring that the executor or administrator does not under-report the estate's value" and serve a "watchdog function." In this case the disclaimant was the executor and a board member of the foundation. Because of her fiduciary obligation, any self-dealing "would be a clear violation of her general state-law fiduciary obligation to put the interests of the foundation above her own interests …"

Conclusion as to this reason: "In general, and on the specific facts of the present case, then, there are sufficient mechanisms in place to promote and police the accurate reporting of estate values beyond just the threat of audit by the Commissioner, thereby undercutting the Commissioner's policy-based argument."

[Observe: References to the attorney general's enforcement of charities' rights would apply only to "formula allocation clauses" with a charity as the "pourover" recipient of the excess value over a described dollar amount. However, the references to the general fiduciary duty of the executor and fiduciary duty of a charitable foundation board member would seem to apply whenever the "pourover" recipient of the excess value under a "formula allocation clause" is a trust.]

Observations

1. <u>General Description of Defined Value Clauses</u>. The major significance of the opinion is not based on the particular fact situation of the case, but that the reasoning of the case rejects the IRS's public policy argument against defined value clauses. A general description of defined value clauses may be helpful to understand the significance of the court's reasoning and of the various observations in this section of the summary.

   There are two general types of defined value clauses.

   a. A "formula transfer clause" limits the amount transferred (i.e., transfer of a fractional portion of an asset, with the fraction described by a formula).

      An example fractional formula transfer clause (with a provision for a small gift being produced if the IRS asserts higher values for gift tax purposes) is as follows:

      > "I hereby transfer to the trustees of the T Trust a fractional share of the property described on Schedule A. The numerator of the fraction is (a) $100,000 plus (b) 1% of the excess, if any, of the value of such property as finally determined for federal gift tax purposes (the "Gift Tax Value") over $100,000. The denominator of the fraction is the Gift Tax Value of the property." McCaffrey, <u>Tax Tuning The Estate Plan By Formula</u>, UNIV OF MIAMI SCHOOL OF LAW PHILIP E. HECKERLING INST. ON EST. PL. ¶402.4 (1999).

   b. A "formula allocation clause" allocates the amount transferred among transferees (i.e., transfer all of a particular asset, and allocate that asset among taxable and non-taxable transferees by a formula). Examples of non-taxable transferees includes charities, spouses,

QTIP trusts, "incomplete gift trusts" (where there is a retained limited power of appointment or some other retained power so that the gift is not completed for federal gift tax purposes), and "zeroed-out" GRATs. With this second type of clause, the allocation can be based on values as finally determined for gift or estate tax purposes, or the allocation can be based on an agreement among the transferees as to values. For example, the McCord case used the second type of clause with the allocation being based on a "confirmation agreement" among the transferees.

The IRS primary position is that these types of clauses should be not be recognized for tax purposes on public policy grounds because they reduce the IRS's incentive to audit returns.

2. Extremely Fast Opinion. The oral argument was on September 22, 2009. (John Porter argued this case 20 minutes before arguing the Holman case before the same three-judge panel of the Eighth Circuit.) The opinion was issued a mere seven weeks later on November 13. (A corrected opinion was issued on November 18, merely changing "Christine's death" to "Helen's death" in the fourth paragraph of the opinion.) This seems to suggest that the judges came to their conclusion very quickly with little difficulty in concluding that such clauses are valid and do not violate public policy.

3. Short Concise Pithy Opinion. The entire opinion is only eight pages long (double-spaced, 12 point font). Despite its shortness, it addresses the major issues with a reasoned and thoughtful analysis including various reasons for its conclusions. (This is somewhat embarrassing to the author of this summary — the opinion is significantly shorter than this summary and analysis of the case.)

4. Unanimous Decisions. The Tax Court was unanimous in its analysis of the validity of the portion of the disclaimer passing directly to the foundation (including the public policy issue) and the Eighth Circuit opinion was also unanimous.

5. Devastating Blow to IRS. The IRS must view this as "that Friday the Thirteenth Horror Case." The case affirms the validity of the formula disclaimer, but more importantly, the analysis of the public policy argument seems to apply to defined value clauses generally. The court's first reason for rejecting the "no incentive to audit" argument (i.e., that the IRS has a duty to enforce the tax laws, not just maximize collections) applies with equal force to all defined value clauses. The second reason (regarding Congressional policy favoring charitable transfers) applies to all "formula allocation clauses" having a charity as the "pourover" recipient. The third reason (regarding fiduciary duties) applies to all "formula allocation clauses" where the "pourover" recipients involve one or more trusts or other entities having trusts or board members with fiduciary duties (even if a charity is not involved).

   This case does not resolve all questions about the effectiveness of defined value clauses. The case does not have a direct holding about defined clauses (the facts involve a formula disclaimer not an inter vivos defined value clause), and it just represents the view of the Eighth Circuit. The Fifth Circuit gave effect to a defined value clause in McCord, but it did not directly address the public policy issue. Still, there are now two federal courts of appeal cases that provide support for these clauses. Despite their limitations, these two federal courts of appeals cases seem to pave the way toward recognition of these clauses. It is a devastating blow to the IRS that the first federal court of appeals case in 65 years to consider the public policy issue ruled against the IRS with very broad reasoning that applies to many types of defined value clauses.

6. Brief Historical Background. This case has been eagerly anticipated as the first federal court of appeals case since the Procter case in 1944 (yes, 65 years ago!) to address the public policy issues

of similar types of clauses where the IRS argues that the clauses should be invalidated because they reduce the IRS's incentive to audit returns.

a. Commissioner v. Procter. In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), cert. denied, 323 U.S. 756 (1944), a transfer instrument provided that if the federal court of last resort held that any part of the transfer was subject to gift tax, the gift portion of the property "shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created." The Fourth Circuit Court of Appeals concluded that the provision imposed a condition subsequent to the transfer, and that the condition subsequent violated public policy for three reasons, discussed in Item 6 below.

   Interesting aside: In Procter, the Fourth Circuit raised the public policy argument on its own. It was not argued by any of the parties.

   Several lower court cases have relied on Procter in refusing to give effect to various types of clauses that reduce the IRS's incentive to audit returns. Indeed, prior to McCord and Estate of Christiansen, the trend of the cases has been to support the Procter result. E.g., Ward v. Comm'r, 87 T.C. 78 (1986) (gift with agreement that if finally determined gift tax value was different, the number of shares transferred would be increased or decreased; court construed agreement as power to revoke and expressed concern that if no challenge took place the "excess value" would pass without tax); Harwood v. Comm'r, 82 T.C. 239 (1984), aff'd, 786 F.2d 1174 (9th Cir. 1986) (transfer of limited partnership units with provision that if value finally determined to exceed $400,000 for gift tax purposes, the trustee was to execute a note back to the donor for the "excess value"); Estate of McLendon v. Comm'r, T.C. Memo 1993-459, rev'd, 77 F.3d 447 (5th Cir. 1995) (appellate opinion does not discuss value clause; Tax Court ignored the adjustment clause, based on Procter and Ward, concluding that it would not expend "precious judicial resources to resolve the question of whether a gift resulted from the private annuity transaction only to render that issue moot").

b. IRS Position; Revenue Ruling 86-41, Revenue Ruling 86-41, 1986-1 T.C. 300 refused to recognize two different types of valuation adjustment clauses contained in a deed of gift of real estate. The first clause provided that the transferee would reconvey to the transferor a sufficient portion of the real estate to reduce the value of the transferred interest to $1,000 as of the date of the gift. The second clause required that the transferee repay to the transferor an amount equal to the excess of the value of the property over $1,000, as determined by the IRS. The Service rejected both of those provisions as a transfer subject to a condition subsequent.

c. McCord v. Commissioner; Fifth Circuit Gives Effect to Defined Value Clause But Does Not Address Public Policy Argument. McCord involves a gift made by a formula giving specified dollar amounts of limited partnership interests to trusts for children and to charities. 461 F.3d 614 (5th Cir. 2006), rev'g, 120 T.C. 358 (2003). Under an assignment by parents, children and trusts for children were to receive limited partnership interests having an aggregate fair market value of $6,910,933 and the excess was to pass to various charities. The allocation was to be based on a "confirmation agreement" among the transferees. The Fifth Circuit held that the IRS had the burden of proof, and the IRS did not meet its burden of proof to rebut values used by the taxpayers. The values of the transferred interests, for purposes of calculating gift and GST taxes, were the values used by the taxpayers (i.e., $89,505 for a 1% interest). The Tax Court erred in using the

confirmation agreement to convert dollar gifts into percentage gifts. Post-gift acts of donees cannot change the value transferred on the date of the gift. The Tax Court should have applied the defined value clause under its plain wording (although the Fifth Circuit stated that the Commissioner chose not to argue the public policy issue and the court did not explicitly consider that issue).

The Fifth Circuit opinion gave no indication whatsoever that the judges viewed the dollar amount assignment as abusive or that it raised "smell test" concerns. To the contrary, the court went out of its way to chide the Tax Court for ignoring the "plain wording" of the dollar value assignment on the basis of its perceived "olfaction." The Fifth Circuit concluded that the Tax Court majority's application of its "smell test" resulted in its failure to give effect to the dollar gifts in the assignment.

7. Procter Distinguished by Tax Court, Not Mentioned by Eighth Circuit. The IRS's position is reminiscent of the 1944 Procter case, in which the Fourth Circuit of Appeals on public policy grounds voided a clause providing that if any part of a transfer is subject to gift tax, the gift portion of the property should automatically be deemed not to be included in the conveyance. Procter cited 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. The Tax Court in Estate of Christiansen specifically distinguished the Procter case and determined that the three reasons cited in Procter are not applicable. As to reasons (2) and (3) in Procter, the Tax 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 Tax Court 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).

8. Choice of Type of Defined Value Clause. "Formula transfer clauses" are simpler to administer and do not require involving a third party. However, "formula allocation clauses" more squarely fall within the court's rationale for rejecting the public policy argument, including having someone with a fiduciary duty to police the valuation. The Tax Court's reasoning for distinguishing Procter (see Item 6 above) applies more directly to "formula allocation clauses." The first reason for rejecting the public policy argument given by the Eighth Circuit (the "duty to enforce tax laws reason") applies to all defined value clauses, but the second and third reasons only apply to "formula allocation clauses" where someone with an interest that is adverse to a lower valuation can police the clause. The fiduciary duty rationale does not apply as strongly to a "formula transfer clause" even if the recipient is a trust, because the fiduciary has no duty to police that an excessive value is not being transferred to the trust. The example "formula valuation clause"

described in Item 1.a of this Observations section provides that the amount transferred will include 1% of any increased value from a gift tax audit. That provides one rationale for arguing that the public policy objection should not apply (because there is still some incentive to audit the return). However, the second and third reasons given by the Eighth Circuit in Estate of Christiansen for rejecting the public policy argument would not be applicable to that type of clause.

9. Structure "Formula Allocation Clauses" to Require Fiduciary Review of Value Determination. The opinion emphasizes that there are other mechanisms to enforce the valuation determination and to thwart "the potential moral hazard or untoward incentive" these clauses might create for undervaluing transfers, specifically emphasizing the fiduciary duties of the parties involved. In this case, the executor as well as the recipients of the transfer had fiduciary duties. In the typical inter vivos transfer using a defined value approach, the transferor does not have a fiduciary duty, but the *recipients* will have fiduciary duties (if the recipients are trusts) to assure that values are proper and that the trust is receiving its appropriate amount. Indeed, the court's rationale referred to the *disclaimant's* fiduciary duty as executor and board member, suggesting that the reasoning would apply even if the *transferor* under a defined value clause were the fiduciary of a trust "pourover" recipient under a "formula allocation clause." However, a stronger rationale would exist if another party, or better yet an independent entity, serves as the fiduciary.

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