

Value Definition Clauses, Part 4: Tax Court in 'Christiansen' Unanimously Rejects IRS Public Policy Arguments

Readers of this column know that I am bullish on the use of "value definition clauses" (VDCs).[1] My two-part columns in March and April 2001 described the what, why and how. I cited the pending *McCord*[2] case as an important test of VDC viability, and concluded with "Keep your eye on *McCord*." My column in December 2006 reported on the taxpayer victory in *McCord*, but wished that the Fifth Circuit Court of Appeals had addressed and put to rest IRS's public policy arguments against VDC's. I cited another pending case as one in which the IRS had raised such arguments, but that case settled in May 2007, without opinion. Fortunately, however, the recent Tax Court opinion in *Estate of Christiansen*[3] unanimously rejected the IRS's public policy arguments. This is great news indeed and should put the final nail in the coffin on IRS challenges to most properly prepared VDCs.[4]

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In *Christiansen*, the decedent left her entire estate to her daughter, but provided that any portion disclaimed would pass to a charitable foundation.[5] The estate consisted in large part of a family limited partnership (FLP), which was appraised after death with a significant discount, and the estate tax return reported a gross estate of about $6,500,000. The daughter filed a timely disclaimer that included a VDC, the desired effect of which was to disclaim all of the estate in excess of $6,350,000. That left only about $150,000 reported as passing to the foundation. Upon IRS audit challenging the value of the FLP, the parties settled on a gross estate of about $9,500,000. Thus, some $3,150,000 would actually pass to the foundation, instead of only $150,000.

The IRS denied any estate tax charitable deduction above $150,000 on the grounds of public policy. After all, if the additional charitable deduction were granted, then the IRS would have lost all incentive to audit, since it could gain no revenue regardless of the estate's value. Quite so, and it is clear that such was the decedent's intent in drafting the will and the daughter's intent in drafting the disclaimer.

The Tax Court majority opinion, with unanimous concurrence, held for the taxpayer, stating the following:

> The Commissioner finally argues that the disclaimer's adjustment clause is void on public policy grounds because it would, at the margins, discourage the IRS from examining estate tax returns because any deficiency in estate tax would just end up being offset by an equivalent additional charitable deduction. … We are hard pressed to find any fundamental public policy against making gifts to charity — if anything the opposite is true. … The Commissioner nevertheless analogizes the contested phrase [in the disclaimer] to the one analyzed in *Commissioner v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, … the Fourth Circuit was faced with a … clause specifying that a gift would be deemed to revert to the donor if it were held subject to gift tax. …. The

> court voided the clause as contrary to public policy, 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 a final judgment. This case is not *Procter*. The contested phrase would not undo a transfer, but only reallocate the value of the property [between the daughter and the foundation]. … If the fair market value of the estate assets is increased for tax purposes, then property must actually be reallocated among the … 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 … We therefore hold that allowing an increase in the charitable deduction to reflect the increase in the value of the estate's property going to the Foundation violates no public policy and should be allowed.

The court went on to point out that the executor is a fiduciary and must not, without fear of breach of fiduciary duty, attempt to "lowball" the value of the estate to cheat the charity. Moreover, foundation directors are fiduciaries who have a duty to obtain the maximum for their charity and can also use tort laws to protect against being cheated. State attorneys general have the power to enforce charitable benefit. Finally, even the IRS Commissioner can curb charitable abuse through sanctions or rescinding a tax exemption, as the Commissioner has done in some notable instances.

So Where Are We Now?

(1) Look for more ways to use VDCs. They can do amazing things. For example, if the formula in *Christiansen* were used with an inter vivos gift, not only would there be an increased gift tax charitable deduction for any increased valuation of the gift resulting from an IRS audit, but also an increased income tax charitable deduction, so that an increased valuation on audit might actually result in a net refund from the IRS to the donor.

(2) Trust *Christiansen* and *McCord*. In *Christiansen* the Tax Court was unanimous on this issue, a rare enough occurrence, especially when the earlier Tax Court opinion in *McCord*, reversed by the Fifth Circuit Court of Appeals, had clearly been hostile to VDC's. Both opinions are good applications of well-established law.

(3) Don't worry about *Christiansen* being a disclaimer case. Merely because *Christiansen* involved a formula in a disclaimer rather than a formula in a will or an inter vivos gift document should not affect the primary holding, i.e., complete rejection of the public policy argument with any similar clause, regardless of context.

(4) Use multiple beneficiaries with a completed transfer of assets. To limit the *Procter* argument, be sure there is no potential reversion of assets to the donor, but only a potential reallocation among the donees, as was true in both *Christiansen* and *McCord*.

(5) Charity as remainder beneficiary is best, but other beneficiaries with fiduciary responsibilities should suffice. Both *Christiansen* and *McCord* involved charity as the remainder beneficiary of the transfer. IRS's public policy argument is clearly weakest with charity as the remainder donee, but even the trustee of a marital trust or other trust as donee has fiduciary responsibilities that cannot be ignored. Still, the boundaries with noncharitable remainder donees are not as clear. Would outright remainder to spouse risk public policy attack? Perhaps, and yet the IRS rarely challenges the values of transfers between spouses. At least one IRS national office representative has stated that they will likely recognize these formulas for spouses or charities, but not beyond. We'll see.

(6) We still lack sufficient guidance for single donee cases, e.g., an inter vivos gift of "$12,000 of FLP interest." Let's hope for further

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developments in that area, but for now, we can take much comfort, and do much good planning, from the law we have. ⚖

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Notes

1. Briefly, a VDC is useful when an irresistible force (i.e., a transfer of wealth, especially when difficult to value, such as a family limited partnership), encounters an immovable object (i.e., a fixed exemption or exclusion such as the annual gift tax exclusion or the federal estate tax exemption). The best known example is a marital deduction formula clause under a will, which allocates a fixed dollar amount to family and the balance to a marital share. A VDC, which can be either inter vivos or testamentary, can either (1) simply allocate a fixed dollar amount to family; or (2) allocate a fixed dollar amount to family and the balance to another entity that causes no further gift or estate taxation, such as spouse outright, marital trust, charity, "zeroed-out" Grantor Retained Annuity Trust (GRAT), or "zeroed-out" Charitable Lead Annuity Trust (CLAT).

2. *McCord v. Comm.*, 461 F.3rd 614 (5th Cir. 2006), revg. 120 T.C. No. 358 (2003).

3. *Estate of Christiansen*, 130 T.C. No. 1 (2008).

4. I say "properly prepared" VDCs because the IRS still can, and no doubt will, attack such clauses that are not within the guidelines set out in *McCord* and *Christiansen*. And I say "most" VDCs because even some formula clauses within the spirit of *McCord* and *Christiansen* might have unusual facts that give pause.

5. The facts as stated are oversimplified. The will provided that 75 percent of any portion disclaimed would pass to a Charitable Lead Annuity Trust (CLAT) and only 25 percent would pass to the foundation. A substantial portion of the opinion (and the primary issue for which this case was discussed in the media) involved whether or not the amount passing to the CLAT would qualify for any charitable deduction (it did not), but that portion of the opinion is irrelevant for this purpose. The much broader issue was whether or not the 25 percent portion passing outright to charity would qualify for estate tax charitable deduction, to the full extent of the increase in estate value upon IRS audit and settlement (it did).

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better suited for easing the park's crowding and traffic flow problems. Senate Endangered Species Act Oversight: "Hearings Before the Subcomm. on Resource Protection of the Senate Comm. on Environment and Public Works," 95th Cong., 1st Sess. 291 (1977) (testimony of Park Superintendent Boyd Evison). Surprisingly, in spite of the citizens' continued arguments and the economics of the situation, neither the TVA nor God Committee official reports considered what was the most profitable element of the river development option — tourism. Archeological treasures, historical sites, and the Great Smoky Mountains National Park offered a unique opportunity for a tourist industry to flourish along the existing river.

11. The NEPA cases have consistently demonstrated the judicial reluctance to pry into the accuracy of public works projects.

12. The author, thanks to an understanding dean in his new academic position in Michigan, was able to spend 2½ days of every week, working out of donated space in national citizen groups' offices — special honor to Friends of the Earth, Sierra Club, National Wildlife Federation, American Rivers — and sleeping on couches and guest beds volunteered by NGO activists in the capital.

13. Ward Sinclair, "'Pork Panic' Sweeping Congress in Wake of Darter's Rescue," *The Washington Post,* June 28, 1978 at A2.

14. These political establishments form "Iron Triangles," as the political scientists call them: political bonds between the agencies that get taxpayer dollars, the private market forces that build the programs and projects, and the congressional blocs that deliver the money in return for power and campaign finance.

15. The Powell Memorandum was prepared by Lewis Powell for the U.S. Chamber of Commerce shortly before he went onto the Supreme Court. In it he decried the creeping socialism dominating America, as exemplified by civil rights, consumerism, and environmentalism, and he called for business to begin funding academic and representational programs and foundations to counteract the 1960s ideologies in American society. The memorandum led directly to the founding of the Heritage Foundation and other similar initiatives. See Lewis F. Powell Jr., "Confidential Memorandum: Attack on American Free Enterprise System" (Aug. 23, 1971).

16. Conversation with Jim Range, Fall, 1978, during hearings on Baker-Culver bill, paraphrased.

17. See Oliver Houck, "With Charity for All," 93 *Yale L.J.* 1415 (1984) (analyzing how industry has created and financed "public interest law firms" as "charitable organizations" to promote business interests against governmental regulation in the public interest).

18. See Murchison at pp. 165, 180.

19. When he called me the evening of the non-veto, apparently seeking absolution, the president indicated that the appropriations committee was able to mobilize too much political force against the darter, despite the actual merits of the economic record.

20. See 49 Fed. Reg. 27,510 (Aug. 6, 1984) (codified at 50 C.F.R. § 17.11 (1985)). Does the darter's currently stabilized survival generally undercut arguments for species protection, or mean that the citizens' litigation seeking to save its last major natural population was a mistake?

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