Estate & Succession Planning Corner

By Lawrence I. Richman

Risk Minimization and the *Christiansen* Decision

A critical aspect of estate planning is the minimization of risk. And in estate planning, risk comes in many forms: valuation risk, unintended gift or estate tax risks, ineffective property transfer risk, the risk that legislative changes to the estate or gift tax laws can make planning obsolete and even the risk that a decedent's family will want to alter the decedent's estate plan posthumously.

The recently issued decision of the Tax Court in *H. Christiansen Est.,*[1] advances the law on the subject of risk minimization by providing practitioners with a deliberate and thoughtful discussion and decision on the use of formulas and savings clauses to effect a desired tax result. The facts in *Christiansen* are straightforward. Helen Christiansen died leaving as her sole heir, her daughter, Christine Christiansen Hamilton, who also was the personal representative of her estate. Mrs. Christiansen's will left her entire estate to her daughter. The will also provided that if her daughter Christine disclaimed any property, 75 percent of it would pass to a charitable lead trust and the other 25 percent would pass to a private charitable foundation the decedent had established. The charitable lead trust was in the form of a charitable lead annuity trust which provided for a twenty-year annuity payable to the family foundation. Based on the government rates then in effect, said annuity was intended to provide a charitable deduction equal to approximately 80 percent of the initial corpus of the trust. The remainder was directed to pass to Christine if she survived the twenty-year term, but if she failed to survive the twenty-year charitable lead trust term, then the remainder was to pass to the family foundation.

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Within nine months of her mother's death, Christine executed a partial disclaimer. Significantly, Christine's disclaimer did not include a disclaimer of her remainder interest in the charitable lead trust. The disclaimer read 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 ($6,350,000.00) 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 Disclaimed Portion"). For purposes of this paragraph, the fair market value of the Gift (before payment of debts, expenses and taxes) on April 17, 2001, shall be the price at which the Gift (before payment of debts, expenses and taxes) would have changed hands on April 17, 2001, between a hypothetical willing buyer and a hypothetical willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts for purposes of Chapter 11 of the [Internal Revenue] Code, as such value is finally determined for federal estate tax purposes.[2]

The Tax Court also noted that the formula disclaimer included a savings clause which said 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."[3]

The following aspects of the disclaimer should be noted. First, the disclaimer was expressed as a fraction of the entire gift. Second, the fraction itself was a defined value formula designed to cap both the value of the property passing to Christine and the taxable portion of the estate at $6,350,000. Third, the formula computed values based on the fair market value of the property as of the Decedent's date of death using the willing buyer/willing seller standard[4] upon which gift and estate tax values are determined. Fourth, the formula contemplated that the values as presented on the Decedent's estate tax return may be adjusted because the fair market value number to be used was the value "as… finally determined for federal estate tax purposes."[5]

One reason the disclaimer focused on the valuation of the Decedent's estate was on account of the pre-death reorganization of the Decedent's farming and ranching business, which for decades had been operated as sole proprietorships, into two family limited partnerships. Decedent retained a 99-percent limited partnership interest in each of these family limited partnerships and Decedent's daughter, Christine, and Christine's husband were the members of a limited liability company that owned a one-percent general partnership interest in the family limited partnerships.

The case reports that the valuation concerns were well founded. Although the valuation issue itself was not before the court, the Tax Court reported that the appraisals submitted with the estate tax return included a 35-percent discount and that the total gross estate as reported on the estate tax return as filed was slightly more than $6.5 million, resulting in $40,555 passing to the Foundation and $121,667 passing to the charitable lead trust. The IRS and the estate settled the valuation issues before trial increasing the total value of the gross estate to close to $9.6 million instead of $6.5 million and increasing the amount passing to the charitable lead trust to $2.4 million and the amount passing directly to the family foundation to $807,000.

Although in a footnote the Tax Court noted that its role was to analyze the legal effect of the estate planning and not its motivation, the body of the opinion includes the Tax Court's own take on what kind of risk minimization planning was occurring.

The Tax Court explained that if the estate reported an unusually low value for the property being disclaimed, Christine would take almost all the value immediately and estate tax would be paid on her $6.35 million. Christine's failure to disclaim her remainder interest in the charitable lead trust meant that when values were adjusted on audit (as was the case) Christine "would capture much of the value of that underreporting as she herself approached retirement age in 20 years' time."[6] For whatever reason, the Tax Court ignored the fact that a change in value would result in an increase in estate tax (because the charitable lead trust was intended to qualify for a roughly 80-percent charitable deduction instead of a 100-percent charitable deduction) and stated: "And if one took an especially skeptical view of the situation, the final quoted phrase in the disclaimer [regarding

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the revaluation of property as finally determined for estate tax purposes] and the savings clause meant that the Commissioner would face an interesting choice if he thought the estate was low-balling its own value—any success in increasing the value of the estate might only increase the charitable deduction that the estate would claim which would presumably reduce the incentive of the Commissioner to challenge the value that the estate claimed for itself."[7]

It appears initially that the IRS may have taken the position that the entire disclaimer was ineffective. However, at the time of trial, it was the IRS's position (1) that Christine's failure to disclaim her remainder interest in the charitable lead trust caused the disclaimer as to 75 percent of the property to be ineffective and (2) that the valuation adjustment clause in the formula disclaimer was ineffective meaning that only the originally reported $40,555 deduction for property passing to the family foundation would be allowed.

The legal consequence of Christine's retention of the remainder interest and whether, where there is a partial disclaimer, the disclaimer should be analyzed under the separate property or severable property disclaimer rules proved internally divisive within the Tax Court.[8] While the court ruled that the disclaimer in favor of the charitable lead trust was ineffective under the regulations and the decision in *Walshire*,[9] it was the court's analysis of the impact of the savings clause that was important to understanding the use of such clauses for risk minimization purposes.

The savings clause provided that the disclaimant "hereby takes such action to the extent necessary to make the disclaimer set forth above a qualified disclaimer." The court held the savings clause ineffective to reform the disclaimer to do whatever required to qualify the transfer to the charitable lead trust for the charitable deduction because it either (1) worked prospectively, in which case it failed the nine-month disclaimer period rules, or (2) failed to identify the property being disclaimed and did not do so unqualifiedly. In eschewing the public policy arguments that frame the discussions of savings clauses, the court made an important point about how such clauses should be approached: namely, they should be viewed in terms of the time frame within which they are intended to operate and should be specific in stating just what they are "saving." In the instant situation, framing the savings clause as a condition precedent as opposed to a condition subsequent and directly stating that the contingent remainder was being disclaimed to the extent necessary to comply with the qualified disclaimer rules may have made the savings clause provisions of the disclaimer effective.

The IRS also made the condition subsequent argument in its disallowance of any increase in the charitable deduction for the property passing to the family foundation. The IRS further argued that the language in the formula disclaimer providing that the fair market value of the disclaimed property would be "as such value is finally determined for federal estate tax purposes" was void as against public policy.

The court rejected the argument that the language "as such value is finally determined for federal estate tax purposes" is a condition subsequent, instead reasoning that the resolution of a dispute about the fair market value of assets as of the date of the Decedent's death "depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future."[10] Accordingly, the valuation language did not constitute a condition subsequent because it did not require new or additional steps; it only involved a resolution of past facts.

On the public policy argument that revaluation clauses discourage the IRS from auditing estate tax returns because of the limited potential for increased revenue, the IRS cited the *Procter*[11] decision, in which the court voided a clause saying a gift would revert to the donor if subject to gift tax because it (1) discouraged tax collection, (2) would undo the gift being analyzed and (3) would upset a final judgment. The court unambiguously rejected applying *Procter* to the disclaimer formula saying that inclusion of the valuation adjustment phrase "would not undo a transfer, but only reallocate the value of the property transferred among [Christine] Hamilton, the [charitable lead] Trust 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 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."[12] In addition, the court noted that the IRS was not the only authority involved and that the state attorney general and the fiduciaries of the estate, trust and foundation all had obligations to settle the estate properly.

By limiting the application of *Procter* the court implicitly recognized that the taxpayer had taken a reasoned approach to dealing with the valuation uncertainty inherent in limited partnership interests. The court

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accepted the fact that there were actual property consequences to a revaluation and that Decedent's transfer was not being undone. The court also recognized that formula clauses shouldn't only be considered in terms of how they impact revenues and that valuation disputes are part of the ordinary estate administration process.

Finally, the advice *Christiansen* provides for practitioners using valuation formula clauses to minimize risk is (1) a defined value clause can work, (2) avoid conditions subsequent, (3) be specific, (4) effect a reallocation for property law purposes and (5) involve parties having fiduciary duties.

Endnotes

1 *H. Christiansen Est.,* 130 TC No. 1, Dec. 57,301.

2 130 TC No. 1, at p. 3.

3 *Id.*

4 *See* Rev. Rul. 59-60, 1959-1 CB 237 *as modified by* Rev. Rul. 65-193, 1965-2 CB 370, and *amplified* by Rev. Rul. 77-287, 1977-2 CB 319, Rev. Rul. 80-213, 1980-2 CB 101 and Rev. Rul. 83-120, 1983-2 CB 170.

5 130 TC No. 1, at p. 3.

6 130 TC 1, at p. 6.

7 *Id.*

8 Ten justices joined in the majority opinion, two of whom issued a concurring opinion disagreeing with the majority on the proper characterization of the property passing to the charitable lead trust, one of whom concurred in part and dissented in part claiming that the disclaimer in favor of the charitable remainder trust should have been treated as a qualified disclaimer of severable property and another justice who also concurred in part and dissented in part holding that Christine's contingent remainder in her charitable lead trust was severable property.

9 *T.J. Walshire,* CA-8, 2002-1 USTC ¶60,439, 288 F3d 342.

10 130 TC No. 1, at p. 10.

11 *F.W. Procter,* CA-4, 44-1 USTC ¶10,110, 142 F2d 824.

12 130 TC No. 1, at p. 11.

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