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Issue Contents

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Are Adjustment Clauses in Disclaimers Void as Against Public Policy?

-by Neil E. Harl*

In a 2009 Eighth Circuit Court of Appeals case, *Estate of Christiansen v. Commissioner*,[1] the issue of fractional or formula disclaimers was raised, with the Eighth Circuit confronted with the assertion by the Internal Revenue Service that ". . . such disclaimers should be categorically disqualified as against public policy."[2] The case involved the estate of a South Dakota rancher who had implemented a rather novel estate plan prior to her death.[3] The appellate court upheld a bequest of property to a charitable foundation as a result of the daughter's disclaimer in an amount that reflected the increased valuation of the property included in the gross estate.[4]

The facts of *Estate of Christiansen*

The decedent in *Estate of Christiansen v. Commissioner*[5] had provided for some property to pass to a charitable lead annuity trust as the result of a disclaimer by the decedent's daughter. That bequest failed because the disclaimer was not a "qualified disclaimer" inasmuch as the daughter's remainder interest was neither "severable property" nor "an undivided portion of the property" as is required in the regulations.[6] Consequently, none of the property passing to the charitable lead annuity trust was eligible for a charitable deduction. This issue was resolved with some adjustments to marketability discounts the estate had claimed for limited partnership interests in the family ranching enterprise and was not appealed to the Court of Appeals.

The Tax Court had held that property passing to a charitable foundation as a result of the daughter's disclaimer did qualify for the charitable deduction.[7] The daughter had disclaimed her interest in the estate as to all amounts over $6.35 million in value. The decedent's will provided that 25 percent of any disclaimed amounts were to go to the charitable foundation. IRS challenged the validity of the disclaimer and also the amount reported as the value of the gross estate. IRS had argued that the act of challenging the estate's estate tax return and the resulting adjustment to the estate's value served as post-death, post-disclaimer contingencies that disqualified the disclaimer under the statute[8] and the regulations.[9] The Tax Court rejected the IRS arguments and approved the property passage to the charitable foundation.

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Happy Holidays to You and Yours!

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The appellate decision

The Eighth Circuit rejected the IRS argument that the amount was uncertain at the time of death and took the position that the regulation only required a transfer at death,[10] not the finality of an accounting as to amount at death. As the court noted, all that remained at death was the valuation of the gross estate, and, therefore, the value of the charitable contribution.[11] The charitable foundation's right to receive 25 percent of the amount in excess of $6.35 million was certain.

IRS also argued that policy concerns dictated that fractional disclaimers should be disallowed that have the effect of disclaiming all amounts above a fixed dollar amount.[12] By the IRS view, such disclaimers fail to preserve a financial incentive for IRS to audit a federal estate tax return. Any post-death adjustment to the value of an estate would affect the charitable deduction, not the tax due.[13] Thus, the IRS argued, such disclaimers should be "categorically disqualified as against public policy."[14] The Eighth Circuit refused to go along with that position and to interpret the statute and regulations in an effort to maximize the incentive to audit. The court's position was that the role of IRS is ". . . not merely to maximize tax receipts and to conduct litigation based on a calculus as to which cases will result in the greatest collection" but to enforce the tax laws.[15] Moreover, the court could find no evidence of a clear Congressional intent suggesting a policy to maximize incentives for IRS to challenge or audit returns. As for the point that the court's holding would encourage executors or administrators deliberately to understate values, the court noted that the contingent beneficiaries would scrutinize such behavior and state law uniformly imposes fiduciary duties on those setting values in estates.

The Eighth Circuit Court of Appeals thus affirmed the Tax Court decision and approved the charitable deduction for the full amount passing to the charitable beneficiary based on the adjustment by formula relating to the change in asset values above $6.35 million. Although not cited in the Eighth Circuit opinion in *Estate of Christiansen*,[16] the Fourth Circuit Court of Appeals in *Estate of Procter*,[17] held that the gift tax could not be avoided by a provision voiding the transfer as to any property subject to gift tax. In that case, the presence of such a provision was considered contrary to public policy and void for federal gift tax purposes. That case was distinguished by the Tax Court in *Estate of Christiansen v. Commissioner*.[18]

ENDNOTES

[1] 2009-2 U.S. Tax Cas. (CCH) ¶ 60,585 (8th Cir. 2009).

[2] *Id*. See generally 5 Harl, *Agricultural Law* § 44.09 (2009); Harl, *Agricultural Law Manual* § 5.02[7] (2009).

[3] Estate of Christiansen v. Commissioner, 130 T.C. 1 (2008), *aff'd*, 2009-2 U.S. Tax Cas. (CCH) ¶ 60,585 (8th Cir. 2009).

[4] *Id*.

[5] 2009-2 U.S. Tax Cas. (CCH) ¶ 60,585 (8th Cir. 2009), *aff'g*, 130 T.C. 1 (2008).

[6] Treas. Reg. § 25.2518-2(e)(3).

[7] 130 T.C. 1 (2008).

[8] I.R.C. § 2518.

[9] Treas. Reg. § 20.2055-2(b)(1).

[10] Treas. Reg. § 20.2055-2(b)(1): "If, as of the date of a decedent's 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, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."

[11] Estate of Christiansen v. Commissioner, 2009-2 U.S. Tax Cas. (CCH) ¶ 60,585 (8th Cir. 2009).

[12] *Id*.

[13] See Rev. Rul. 86-41, 1986-1 C.B. 300 (value of gift of real estate was determined without regard to an adjustment clause in the deeds of transfer providing for a recharacterization of the transaction depending upon the valuation of the transferred property by the Internal Revenue Service). See also TAM 9309001, September 30, 1992 (value of donor's gift of limited partnership interest not limited to a specified dollar amount because of the adjustment provisions contained in the transfer documents).

[14] *Id*.

[15] I.R.C. § 7801(a).

[16] 2009-2 U.S. Tax Cas. (CCH) ¶ 60,585 (8th Cir. 2009).

[17] 142 F.2d 824 (4th Cir. 1944), 142 F.2d 838 (4th Cir. 1944), *cert. denied*, 323 U.S. 756.

[18] 130 T.C. 1 (2008).