Estate of Arthur E. Schaefer, Deceased, Kathleen J. Wells, Executor v. Commissioner of Internal Revenue, 145 T. C. 134 (U. S. Tax Court 2015)

In a significant ruling, the U. S. Tax Court held in Estate of Schaefer v. Commissioner that the valuation of charitable remainder interests in net income with makeup charitable remainder unitrusts (NIMCRUTs) must use the fixed percentage specified in the trust instrument, not the actual net income distributed. This decision impacts how estates calculate charitable contribution deductions, potentially reducing the value of such deductions when the fixed percentage exceeds the trust's income.

Parties

The petitioner, Estate of Arthur E. Schaefer, with Kathleen J. Wells as the executor, sought a charitable contribution deduction from the respondent, the Commissioner of Internal Revenue, regarding two irrevocable charitable remainder trusts established by the decedent.

Facts

Arthur E. Schaefer established two irrevocable charitable remainder unitrusts (CRUTs) in 2006, each designed to benefit one of his sons during their lifetimes or a term of years, with the remainder passing to a charitable organization. The trusts were structured as net income with makeup charitable remainder unitrusts (NIMCRUTs), where the trustees were required to distribute the lesser of each trust's annual income or a fixed percentage (11% for Trust 1 and 10% for Trust 2) of the net fair market value of the trust assets. If trust income exceeded the fixed percentage, additional distributions could be made to cover prior years' shortfalls. After Mr. Schaefer's death in 2007, his estate sought a charitable contribution deduction for the value of the charitable remainder interests in these trusts.

Procedural History

The estate filed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, but did not initially claim a charitable contribution deduction for the trusts. Following an IRS audit, a notice of deficiency was issued on March 7, 2011, denying the estate's claim for a charitable contribution deduction on the grounds that the trusts did not meet the statutory requirement that the charitable remainder interest be at least 10% of the net fair market value of the contributed property. The estate timely petitioned the U. S. Tax Court for review. The case was submitted fully stipulated under Tax Court Rule 122, and the court focused on the issue of the appropriate distribution amount for calculating the charitable remainder interest value.

Issue(s)

Whether the value of the charitable remainder interest in a net income with makeup

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charitable remainder unitrust (NIMCRUT) should be calculated using the fixed percentage stated in the trust instrument or the trust's actual net income for determining the estate's eligibility for a charitable contribution deduction under I. R. C. § 664(d)(2)(D)?

Rule(s) of Law

Under I. R. C. § 664(d)(2)(D), for an estate to claim a charitable contribution deduction for the remainder interest in a CRUT, the value of the remainder interest must be at least 10% of the net fair market value of the property contributed to the trust. I. R. C. § 664(e) provides that the remainder interest of a CRUT shall be computed on the basis that an amount equal to 5 percent of the net fair market value of its assets (or a greater amount, if required under the terms of the trust instrument) is to be distributed each year.

Holding

The U. S. Tax Court held that the value of the charitable remainder interest in a NIMCRUT must be calculated using the fixed percentage stated in the trust instrument (11% for Trust 1 and 10% for Trust 2) rather than the trust's actual net income for determining the estate's eligibility for a charitable contribution deduction under I. R. C. § 664(d)(2)(D).

Reasoning

The court found I. R. C. § 664(e) to be ambiguous in describing how to value the charitable remainder interest in a NIMCRUT, where actual distributions could be less than the fixed percentage. The court looked to legislative history and administrative guidance for interpretation. The Senate report accompanying the Tax Reform Act of 1969 indicated that the fixed percentage should be used for valuation purposes despite the net income limitation. The IRS's consistent administrative guidance in Rev. Rul. 72-395 and Rev. Proc. 2005-54 further supported this interpretation. The court determined that this approach, although potentially undervaluing the remainder interest if the trust produced insufficient income, was consistent with the legislative intent to prevent manipulation of trust investments to favor income beneficiaries over charitable remainder beneficiaries. The court rejected the estate's argument that the trust's expected income based on the section 7520 rate should be used for valuation purposes, finding no statutory basis for this approach.

Disposition

The court sustained the Commissioner's determination denying the estate's claim for a charitable contribution deduction, as the stipulated facts indicated that the trusts did not meet the 10% requirement when valued using the fixed percentage method. The decision was to be entered under Tax Court Rule 155.

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Significance/Impact

This decision clarifies the valuation methodology for charitable remainder interests in NIMCRUTs, requiring the use of the fixed percentage specified in the trust instrument rather than the actual net income distributed. This ruling has significant implications for estate planning involving charitable remainder trusts, potentially affecting the value of charitable contribution deductions. The court's reliance on legislative history and administrative guidance underscores the importance of these sources in interpreting ambiguous statutory provisions. Subsequent courts and practitioners will need to consider this decision when structuring and valuing NIMCRUTs to ensure compliance with the statutory requirements for charitable contribution deductions.

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