Steve Leimberg's Charitable Planning
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Subject: Richard L. Fox and Jonathan G. Blattmachr on *Estate of Miriam M. Warne* - Decedent's Splitting of Charitable Bequest of 100% LLC Membership Interest Between Two Separate Charities Results in Mismatch of Value Included in Gross Estate and Amount Allowed As Estate Tax Charitable Deduction

"The recent Tax Court decision in Estate of Miriam M. Warne is a cautionary tale on splitting a testamentary bequest between two separate charities where doing so will cause a mismatch in the amount included in the gross estate and the amount allowable as a charitable estate tax deduction. In this case, the decedent owned a 100% membership interest in a single member limited liability company ("LLC") having a stipulated value of $25,600,000. Although the entire 100% interest in the LLC was distributed to charity, the decedent divided the distribution between two separate charities, giving a 75% membership interest to her family private foundation and the remaining 25% interest to her church.

On the basis of the United States Court of Appeals for the Ninth Circuit decision in the Ahmanson Foundation, the Tax Court held that the amount of the charitable estate tax deduction must be based on what is actually received by each of the charities and that the 75% membership interest received by the foundation and the 25% membership interest received by the church were both subject to valuation discounts. The total combined discounted value of the 75% membership interest passing to the foundation and the 25% membership interest passing to the church was equal to only $21,405,796, over $4 million less than the gross estate tax value and thereby subjecting an asset that ultimately was distributed entirely to charity to be subject to substantial estate tax.

The result in Warne certainly seems unfair in some ways but it can be avoided by the decedent bequeathing the entire interest in his or her gross estate to one charity, such as a family foundation which, in turn, could transfer an interest in the property it receives to one or more other charities. And, unlike gifts for income tax purposes, an unlimited estate or gift tax charitable deduction is allowed for transfers to private foundations. Hence, *this type of disposition should be considered where there is desire a make bequests of interests in one entity or one piece of property to more than one charity."*

Richard Fox and **Jonathan Blattmachr** provide members with commentary that examines *Estate of Miriam M. Warne*.

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Here is their commentary:

EXECUTIVE SUMMARY:

The recent Tax Court decision in *Estate of Miriam M. Warne* is a cautionary tale on splitting a testamentary bequest between two separate charities where doing so will cause a mismatch in the amount included in the gross estate and the amount allowable as a charitable estate tax deduction. In this case, the decedent owned a 100% membership interest in a single member limited liability company ("LLC") having a stipulated value of $25,600,000. Although the entire 100% interest in the LLC was distributed to charity, the decedent divided the distribution between two separate charities, giving a 75% membership interest to her family private foundation and the remaining 25% interest to her church.

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FACTS:

Background

In *Estate of Miriam M. Warne v. Comm'r*, T.C. Memo. 2021-17 (February 18, 2021), the gross estate of the decedent, who died in 2014, included a 100% membership interest in Royal Gardens, LLC ("Royal Gardens"), a single member limited liability company. Royal Garden held an interest in a mobile home park and had a stipulated fair market value of $25,600,000 at the time of the time of the decedent's death. The Royal Gardens 100% membership interest was actually held in a family trust, known as the "Warne Family Trust," of which Mrs. Warne was the trustee and, as trustee, served as the manager of Royal Gardens. Although not addressed in the facts of the Tax Court opinion, the Warne Family Trust was apparently a revocable trust, thereby causing the Royal Garden 100% membership interest to be included in Mrs. Warne's gross estate under IRC § 2038, essentially as if she owned the membership interest in her own right upon her death.

Pursuant to a Ninth Amendment to the Warne Family Trust, upon the decedent's death, a 75% membership interest in Royal Gardens was required to be contributed to the Warne Family Charitable Foundation ("Foundation") and the remaining 25% membership interest contributed to the St. John's Lutheran Church ("Church"). Both the Foundation and the Church are charitable organizations described in IRC § 501(c)(3), bequests to which are deductible for estate tax purposes under IRC § 2055.

On the estate's Schedule O, Charitable, Public, and Similar Gifts and Bequests, of its Form 706 (United States Estate (and Generation-Skipping Transfer) Tax Return, the estate listed as charitable donations the 75% membership interest in Royal Gardens passing to the Foundation at a value of $19,200,000 and the 25% membership interest in Royal Gardens going to the Church at a value of $6,400,000 (or one-third of the 75% interest passing to the Foundation). Combined, those amounts equaled the full $25,600,000 fair market value of the 100% membership interest in Royal Gardens included in the decedent's gross estate, thereby resulting in no estate tax being reported on the Form 706 with respect to the 100% membership interest in Royal Gardens.

In connection with its audit of the estate, the IRS reduced the estate tax charitable contribution deduction claimed on Form 706 for the "split donation of Royal Gardens" between the Foundation and the Church from the $25,600,000 claimed on the Form 706 to $21,405,796, an over $4 million reduction, on the basis that valuation discounts should be applied for purposes of determining the value of the respective interests transferred to the Foundation and the Church.

At trial, the IRS contended that valuation discounts should be applied for lack of control and lack of marketability with respect to the 25% Royal Gardens membership interest contributed to the Church and a lack of marketability discount should be applied to the 75% Royal Gardens membership interest contributed to the Foundation because "the value of the deduction should reflect the benefit received by the respective donees."

The estate, contrary to the position of the IRS, countered that the application of valuation discounts "would subvert the public policy of motivating charitable donations," further asserting that "because 100% of Royal Gardens was included in the estate and the estate donated 100% of Royal Gardens to charities, the estate is entitled to a deduction of 100% of Royal Gardens' value."

Analysis and Holding of Tax Court

In its opinion, the Tax Court in *Warne* noted that both the decedent's estate and IRS cited for support the case of *Ahmanson Foundation v. U.S*., 674 F.2d (9th Cir. 1981). In *Ahmanson Foundation*, the decedent owned (through a revocable trust) 100% of the shares of a corporation, consisting of one voting share and 99 nonvoting shares. Instead of donating all 100 shares to one single beneficiary, the decedent bequeathed the one voting share to his son and the 99 nonvoting shares to a family charitable foundation.

The United States Court of Appeals for the Ninth Circuit in *Ahmanson Foundation* stated that "[t]here is nothing in the statutes or in the case law that suggests that valuation of the gross estate should take into account that the assets will come to rest in several hands rather than one." As such, the one voting share and the 99 nonvoting shares in *Ahmanson Foundation* were not viewed for gross estate tax valuation purposes as two distinct assets to be valued separately, but were valued on the basis of the 100 combined shares held as one block by the estate at the decedent's death. On this basis, the Tax Court in *Warne* stated that "when valuing an asset as part of an estate, we value the entire interest held by the estate, without regard to the later disposition of that asset" which, in this case, was the value of the 100% membership interest in Royal Gardens held by the family trust, or $25,600,000.

The Tax Court then stated that when property held by an estate is split as part of a charitable contribution, a different principle applies, quoting the Court of Appeals in *Ahmanson Foundation* as follows: "The valuation of these same sorts of assets for the purpose of the charitable deduction, however, is subject to the principle that the testator may only be allowed a deduction for estate tax purposes for what is actually received by the charity -- a principle required by the purpose of the charitable deduction."

Recognizing that this principle may cause the valuation of an asset for gross estate tax inclusion purposes to exceed the valuation of the same asset for estate tax charitable deduction purposes, the Court of Appeals in *Ahmanson Foundation* further stated that IRC § 2055, under which Congress provided for the estate tax charitable deduction, "does not ordain equal valuation as between an item in the gross estate and the same item under the charitable deduction. Instead, it states that the value of the charitable deduction 'shall not exceed the value of the transferred property required to be included in the gross estate.'" IRC § 2055(d). The court *Ahmanson Foundation* applied a 3% valuation discount in valuing the 99 nonvoting shares received by the charity to account for the lack of voting rights of such shares, although no valuation discount was applied in valuing the same 99 nonvoting shares for gross estate tax purposes given that the estate also owned the one voting share.

Relying on the *Ahmanson Foundation* case, in determining the value for purposes of the available estate tax charitable deduction of the 75% and 25% membership interests in Royal Gardens contributed, respectively, to the Foundation and Church, the Tax Court in *Warne* stated that "we do not value what an estate contributed; we value what the charitable organization received."

Taking the foregoing principles together, the Tax Court held that the gross estate in *Warne* must include the value a 100% membership interest in Royal Gardens and the charitable deduction must be based on the value of the respective 25% and 75% interests received by the Foundation and the Church, which would take into account any applicable valuation discounts attributable to such separate interests.

The estate in *Warne* sought to distinguish its donation from the one in *Ahmanson Foundation*, emphasizing that the voting shares in that case went to the decedent's son and not to a charitable organization, whereas in this case 100% of the decedent's membership interest in Royal Gardens' went to charitable organizations, so that there was no split of the membership interest between a noncharitable beneficiary and a charitable beneficiary as there was in *Ahmanson Foundation.* Because Mrs. Warne devised her entire interest in Royal Gardens to charity, the estate asserted that a valuation discount should not apply in computing the available charitable estate tax deduction.

The Tax Court disagreed, stating that whether a charitable organization or an individual received the 75% membership interest in Royal Gardens does not affect the value of the Church's 25% membership interest, stressing again that “it is the value of the property received by the donee that determines the amount of the charitable deduction available to the donor.” Thus, the fact that the assets in *Ahmanson Foundation* were divided between a charity and an individual, as opposed to being divided between two charitable organizations, was not considered relevant, as the Tax Court held that the available charitable deduction under IRC § 2055 must be based only on the value of the property that each charitable organization receives. A 27.385% valuation discount was applied to the 25% interest received by the Church and a 4% discount was applied to the 75% interest received by the Foundation, which were the valuation discounts that the parties had made a conditional stipulation prior to trial.

COMMENT:

The *Warne* case highlights the potential for a substantial “mismatch” between the value of property included in the gross estate and the amount of the corresponding charitable estate tax deduction where a testamentary disposition of the same property is split between beneficiaries, even if all of the beneficiaries receiving interests in the property are qualified charitable organizations under IRC § 2055. In *Warne,* the mismatch resulted in an increase in the taxable estate by over $4 million, which at the 40% estate tax rate in effect at Mrs. Warne’s death, would result in the estate owing about $1,600,000 in estate tax that was never anticipated. Where the estate tax burden is born in whole or in part on the charitable bequests, the effect would increase the estate tax to an even great degree by reason of IRC § 2055(c) which directs that any tax paid by a disposition in favor of charity must be reduced by estate tax that must be paid by the disposition.

Similar to *Warne* and the *Ahmanson Foundation* situations for valuing a deduction for property passing to charity, the Tax Court in *Estate of Chenoweth*, 88 TC 1577 (1987), held that symmetry is not required in valuing assets for the gross estate tax purposes and marital deduction purposes. In *Chenoweth*, the decedent, transferred his 100% ownership of a company into two unequal shares, a majority interest to his surviving spouse and a minority interest to his children. The majority interest had a control premium that was taken into account in determining the amount of the marital deduction.

A mismatch in the value of a gift or bequest and the value of a charitable deduction can arise in other contexts as well. This could be the case, for example, where the "indirect gift theory" is successfully applied to a lifetime transfer of assets to a family limited partnership, followed by a contribution of an interest in the partnership to a charitable lead trust described in IRC § 2522(c)(2)(B) or other entity where a charitable deduction would be allowed in whole or in part. In this case, the intermediary partnership would be ignored in determining the amount of the gift so that the contribution to the charitable lead trust would be considered to be a portion of the value of the assets transferred to the partnership, and not a contribution of a partnership interest. *See, e.g., Holman*, 130 T.C. 170 (2008), aff'd, 105 AFTR 2d 2010-1802 (8th Cir. 2010); *Heckerman v. United States*, 104 AFTR2d 2009-5551, 2009-5553 (WD Wash. 2009).

No valuation discount would be taken in determining the amount of the gift but, because the charitable lead trust does, in fact, actually receive an interest in the partnership, the charitable gift tax deduction would be based on the value of the interest in the partnership passing to the lead trust subject to any appropriate valuation discounts. Therefore, the value of the gift would be based on an undiscounted value but the charitable deduction would, to the extent applicable, be based on a discounted value. And, see *Estate of Powell v. Comm'r*, 148 TC 392 (2017), where both the value of the partnership units owned by the decedent and the underlying assets of the partnership were both included in the decedent partner's gross estate. Although the Tax Court in *Powell* allowed an offset under IRC § 2043 to avoid full double taxation on both the value of the partnership units and the underlying partnership assets, presumably a bequest of even all the units to one charity would have resulted in a mismatch of the amount included in the gross estate and the charitable deduction allowed.

As noted above, the estate in *Warne* argued it had properly deducted the full value of a 100% membership interest in Royal Garden because, unlike in the *Ahmanson Foundation* case, Mrs. Warne devised her entire interest in Royal Gardens to charity, and that applying valuation discounts to determine the value passing to charity in such a case "would subvert the public policy of motiving charitable donations." In *Ahmanson Foundation,* the United States Court of Appeals for the Ninth Circuit also addressed public policy in its opinion, stating the following:

> In light of the purpose of the charitable deduction to encourage gifts to charity, it seems doubtful that Congress intended to give as great a charitable deduction when the testamentary plan diminishes the value of the charitable property as it would when the testamentary plan conveys the full value of the property to the charity intact. That is, the intent of encouraging charitable gifts suggests the further policy of encouraging greater rather than lesser charitable gifts. By severing the voting power of the stock from its economic entitlement, and giving only the economic entitlement to charity, Ahmanson reduced the value of the stock to the charity.

Unlike in *Ahmanson Foundation,* the decedent in *Warne* did not adopt a testamentary plan severing the voting power of Royal Gardens from its economic entitlement and then give only an economic entitlement to charity. Nor did she take any other affirmative steps to diminish the value ultimately passing to charity. Instead, the decedent merely gave a 75% membership interest in Royal Gardens to one charity and the remaining 25% membership interest to another charity. Query whether the purpose of the charitable deduction of encouraging charitable gifts would be any better effectuated by requiring the decedent in this situation to give her entire interest in Royal Gardens to either her family foundation or to her church, rather than allowing her to allocate such interests among charities as she desires?

The IRS has actually been more lenient in certain cases when it comes to the application of valuation discounts for property contributed to charity. In Rev. Rul. 57-293, 1957-2 CB 153, for example, the IRS ruled that the charitable income tax deduction for a contribution of a fractional interest in artwork to a museum was equal to its fair market value multiplied by the fractional interest conveyed. The ruling did not indicate that any valuation discount should be applied because only a fractional interest in the artwork was received by the museum, a situation where a valuation discount is typically applied by the IRS. See also Ltr. Rul. 200223013 (charitable income tax deduction for a contribution of undivided interest in works of arts is equal to the fair market value multiplied by the fractional interest) (not precedent).

Query what the result would be where an individual who owns a $10 billion art collection gives at his or her death a 50% fractional interest in the collection to the Metropolitan Museum of Art and the remaining 50% fractional interest to the National Gallery of Art? The $10 billion would clearly be included in his gross estate but should the charitable estate tax deduction be any less than the same $10 billion included in the gross estate? Any valuation discount applied in determining the charitable estate tax deduction on the basis of what is actually received by the charities would result in significant estate taxes being imposed merely because the decedent desires for the collection to be displayed at two of the country's great museums following his death. Would the purpose of the charitable deduction be better served by requiring the collection in such a case to be given to only one of the museums? Or should a valuation discount not be applied where the asset being donated is used directly for the charitable purposes of the donee charity, such as works of art to be displayed by a museum?

The *Warne* case, which is appealable to the United States Court of Appeals for the Ninth Circuit, the same court that decided *Ahmanson Foundation*, would seem ripe for an appeal.

Conclusion

The result in *Warne* certainly seems unfair in some ways but it can be avoided by the decedent bequeathing the entire interest in his or her gross estate to one charity, such as a family foundation which, in turn, could transfer an interest in the property it receives to one or more other charities. And, unlike gifts for income tax purposes, an unlimited estate or gift tax charitable deduction is allowed for transfers to private foundations. Hence, this type of disposition should be considered where there is desire a make bequests of interests in one entity or one piece of property to more than one charity.

And there is one bit of good news: The IRS itself has acknowledged discounts for gifts to family members of fractional interests in shares of stock of a company. It is interesting to note that the discount was found to be greater for a smaller fractional interest. This may be especially important to consider when making lifetime gifts to individuals. See Rev. Rul. 93-12, 1993-1 CB 202.

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Richard Fox
Jonathan Blattmachr

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Estate of Miriam M. Warne v. Comm'r, T.C. Memo. 2021-17 (February 18, 2021), *Holman v. Comm'r*, 130 T.C. 170 (2008), aff'd, 105 AFTR 2d 2010-1802 (8th Cir. 2010); *Heckerman v. United States*, 104 AFTR2d 2009-5551, 2009-5553 (WD Wash. 2009); *Ahmanson Foundation v. U.S*., 674 F.2d (9th Cir. 1981); *Estate of Chenoweth v. Comm'r*, 88 TC 1577 (1987); *Estate of Powell v. Comm'r*, 148 TC 392 (2017); Rev. Rul. 57-293, 1957-2 CB 153; Rev. Rul. 93-12, 1993-1 CB 202.