Tax Court Finds Gift on Trust Commutation

Take-Away: Trust modifications and early terminations carry with them the risk of indirect gifts by one or more of the trust beneficiaries. That seems to be a recurring theme in the Tax Court these days.

Background: A recent trend is that the IRS looks for taxable gifts when a trust is modified, decanted, or a trust is terminated. While this has been a mild passing concern in the past, there now seems to be a frontal assault by the IRS on the modification or termination of trusts under the Uniform Trust Code's various trust modification or termination provisions in the search for taxable gifts. Yet another recent case from the Tax Court brings home the risks associated with trust modifications and early trust terminations by trust beneficiaries.

McDougall v. Commissioner, 163 Tax Court, No. 5, September 17, 2024

Facts: Clotilde died in 2011. At that time, her estate was valued at $59.76 million. Her husband Bruce was Personal Representative and trustee of a 'QTIPable' trust. Bruce formally elected QTIP treatment for the trust, to be sheltered by the unlimited marital deduction, effectively sheltering $54 million from federal estate taxation. Their two children, Linda, and Peter were the residuary beneficiaries of the QTIP trust. Discretionary distributions could be made to Bruce under a HEMS distribution standard. Bruce was also given a testamentary power of appointment over the QTIP Trust to Clotilde's descendants, either outright or in further trust. By 2016 the QTIP trust's assets had more than doubled. At that time Bruce and the children agreed that the trust assets could be more effectively used if Bruce held them outright and free from trust. Accordingly, in 2016 Bruce, Linda and Peter executed a Nonjudicial Settlement Agreement concerning the termination of the QTIP trust and the distribution of the trust assets.

Nonjudicial Settlement Agreement: The Nonjudicial Agreement provided for a commutation of the entire QTIP trust corpus, which was deemed by the agreement to be distributed outright to Bruce. The Agreement also provided that Bruce would then sell the former QTIP assets to Linda and Peter in exchange for promissory notes. The Agreement also expressly addressed IRC 2519 in which it concluded that the commutation was not a deemed gift by Bruce, which it would otherwise be treated as such under IRC 2519 as a deemed gift of the entire QTIP corpus, since the QTIP trust assets passed to him, and not a third-party, and the trust assets were already taxable in his estate since it was a QTIP trust. This Nonjudicial Agreement also contained a self-serving statement that the deemed gift of the

remainder interest from Bruce to Peter and Linda, and the gift from Linda and Peter to Bruce resulted in a reciprocal gift transfer, meaning it was no taxable gift by any of the three.

Tax Court: The full Tax Court found that there was no taxable gift by Bruce with the commutation of the QTIP trust. However, it found that Linda and Peter had made taxable gifts by virtue of their surrender of the remainder interest in the QTIP trust to Bruce.

Bruce: The Tax Court rejected the IRS's contention that IRC 2519 applied when the QTIP trust was commuted. It found: "*As in Estate of Anenberg v. Commissioner, No. 856-21, 162 Tax Court – (May 20, 2024), the Commissioner maintains that the implementation of the Nonjudicial Agreement resulted in a gift made by Bruce, or in the alternative, that the implementation of the Nonjudicial Agreement coupled with the subsequent sale of the trust property for promissory notes resulted in a gift made by Bruce. We reject these arguments for the reasons we set out in Estate of Anenberg. As with respect to Sally [Anenberg] in that case, we conclude that Bruce made no gifts to Linda or Peter….Accordingly, as in Estate of Anenberg, we leave for another day the complicated question of whether implementing the Nonjudicial Agreement gave rise to 'any disposition' of Bruce's qualifying income interest for purposes of section 2519(a).*"

Linda and Peter: The children did not fare as well as did Bruce at the Tax Court. The children received a remainder interest in the QTIP trust at Clotilde's death. This was a valuable property interest that became a part of their estates at that time. Linda and Peter agreed in the Nonjudicial Agreement to the immediate transfer of their interests in the trust to Bruce. Since the federal gift tax is an excise tax on the transfer of property, the transfer of Linda and Peter's rights to a pro rata share of the residuary QTIP trust assets was a taxable gift.

In response to the children's 'reciprocal gift' argument, the Tax Court concluded that because the trust assets are no longer part of either of Linda and Peter's taxable estates after the commutation, the same assets cannot be further transferred by Linda and Peter; in short, the assets are no longer subject to further transfer taxation, i.e., there was no reciprocity of gifts.

While Linda and Peter seemed to argue that somehow IRC 2519(a) applied equally to them as to Bruce, the Court found otherwise. The Court found that IRC 2519 "*does not deem a gift; it merely deems a transfer. Thus, there are no deemed gifts from Bruce to Linda and Peter to offset the very real gifts from Linda and Peter to Bruce.*"

Value of Gifts by the Children: The Tax Court did not decide the value of the gifts of their remainder interests by Linda and Peter. It left that question open to further proceedings in the Court, which might lead to a finding of tens of millions of dollars in gifts made by each child, considering the size of the QTIP corpus in 2016 over well over $100 million.

But it is not all that easy a task to assign a value to their gifted remainder interests. The proper test goes back to the long-established fair market value 'test.' [Revenue Ruling 59-60.] What is the fair market value of Linda and Peter's interest in the QTIP residue, considering: (i) trust principal could be distributed to Bruce following the HEMS distribution standard; and (ii) their interest in the QTIP trust could be completely divested through Bruce's exercise of the testamentary limited power of appointment that he held over the QTIP corpus? And consider the fact that since the children are not twins, the younger of the two children, with a longer life expectancy, will be deemed to have made a larger gift than the other. How will a child's remainder interest in the QTIP trust be determined if the child's remainder interest can be eliminated by Bruce by simply directing the QTIP trust assets elsewhere using his testamentary power of appointment over the entire QTIP trust corpus? These will not be easy questions to answer when the attempt is made to value the 'gifted' remainder interest in the QTIP trust.

Conclusion: Both the *Anenberg* and *McDougall* decisions, decided within 4 months of each other, are both a reminder of the unusual, deemed *disposition* provisions of IRC 2519 when any interest in a QTIP trust is disposed of by the spouse-beneficiary. Perhaps more importantly, the IRS's search for an indirect gift by trust beneficiaries when trusts are modified, terminated, decanted, or in some fashion altered, creates a risk that always will need to be assessed. And as the valuation issues in *McDougall* get hashed out in further court proceedings, the challenge of finding the fair market value of a remainder interest in the trust becomes very real. While Linda and Peter stood to inherit 50% of $100+ million on Bruce's death, what would someone really pay if the child (not hindered by a spendthrift provision) wanted to sell their remainder interest in the QTIP trust? Knowing that Bruce, exercising his testamentary power of appointment could completely disinherit the child, would a buyer offer much considering that large risk?

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