

Early Terminations of Trusts- The Valuation Challenge Conundrum

Take-Away: The early termination of an irrevocable trust can lead to deemed gifts by the trust remainder beneficiaries. The challenge is how to go about valuing those deemed gifts. The Tax Court has now provided some guidance in calculating deemed gifts, addressing some interesting valuation arguments.

Background: The past few years have resulted in more than a couple of missives that have addressed the unexpected gift tax consequences of an early termination of an irrevocable trust. A noteworthy Tax Court decision previously covered that dealt with the early termination of a QTIP trust was *McDougall vs Commissioner*, 163 Tax Court 112 (2024) where the Tax Court held that the termination of the QTIP trust created a deemed gift by the remainder beneficiaries of that trust to their parent. That decision, however, did not explain how the value of that deemed gift by the remainder beneficiaries was to be calculated. Two years later there is now a 'follow-up' Tax Court Memo decision that provides some guidance in the calculation of deemed gifts, with a surprise that the state law, rather than IRS actuarial tables [IRC 7520] govern the underlying deemed property interest transfers that result from a trust's termination.

McDougall v. Commissioner, Tax Court Memo, 2026-58

Facts: Clotilde died in 2011. Her children Linda and Peter, and her husband Bruce, were the beneficiaries of a Residuary Trust. Bruce was the lifetime beneficiary. Clotilde's primary asset was a real estate business that she inherited from her father. A QTIP election was made for this trust. [IRC 2056(b)(7).] Bruce also had a testamentary limited power of appointment over the QTIP trust. In 2016 Bruce executed a Will in which he attempted to exercise the testamentary power of appointment, directing the QTIP assets to his revocable trust on his death. Four months later Bruce, Linda and Peter entered into a nonjudicial settlement agreement under Washington's trust and probate laws to commute the QTIP trust, with the entire remaining balance of the QTIP assets distributed outright to Bruce, free from the trust. That agreement did not establish any reserve for the payment of federal transfer taxes. At the time of the trust's commutation, the value of the QTIP trust assets was \$114,604,143.

Initial Tax Court Decision: In its summary judgment decision, the Tax Court looked at the nonjudicial settlement agreement and concluded that Bruce who ended up owning all the QTIP assets did not make any gift.[IRC 2519.] However, the Court did find a taxable gift by Linda and Peter. “Before the implementation of the Nonjudicial Settlement Agreement Linda and Peter held valuable rights, i.e., the remainder interests in the QTIP. By consenting to the transfer of all QTIP trust assets to Bruce they gave up those valuable remainder interests, and they received nothing in return. By giving up something for nothing, the children engaged in quintessential gratuitous transfers and are therefore subject to gift tax under sections 2501 and 2511.” The Court then found that the value of the taxable gifts equaled the value of the terminating distributions the children would have been entitled to receive under the terms of Clotilde’s Will (and Residuary Trust) had they not agreed to distribute all the assets to Bruce. The litigation then turned to the valuation of the deemed gifts by the children.

Recent Tax Court Dispute: The IRS claimed that Peter and Linda each made taxable gifts of \$53,408,746. Peter and Linda argued that the value of their respective deemed gifts was \$156,000, or in the alternative, no more than \$34.9 million (talk about alternate positions asserted by the kids!) This valuation dispute regarding the deemed gift by the remainder beneficiaries centered on some interesting assertions, no doubt due in large part to the amount of the gift tax liability in controversy:

- (i) whether the valuation of Peter and Linda’s remainder interests warranted a deep discount due to the presence of Bruce’s testamentary limited power of appointment over the trust corpus where, if exercised, Peter and Linda could be fully disinherited by Bruce’s exercise of that limited power of appointment.
- (ii) whether the deemed gifts should be reduced by the net gift mechanism of IRC 2207A to reflect that avoided the children’s reimbursement obligation [more on this Tax Code section below.]
- (iii) whether Peter and Linda’s remainder interests in the trust had to be valued using the IRS actuarial tables found under IRC 7520; and
- (iv) whether Bruce’s life expectancy should be adjusted downward by five years from the standard actuarial table due do his high income and perceived good health.

IRC 2519(a): Recall that this Tax Code section provides that if the surviving spouse disposes of their qualifying income interest in a QTIP trust, that spouse is treated as having made a deemed gift of ‘all interests’ in that trust other than their qualifying income interest. In the first Tax Court decision, since Bruce ended up owning all the QTIP trust assets, he did not make a gift under IRC 2519 as found by the Tax Court.

IRC 2207A: Before we get to the competing calculations, what follows is a short summary of IRC 2207A and how it impacts the remainder beneficiaries. Under the QTIP trust rules, if Peter and Linda had received something upon the termination of the QTIP trust equal in value to their remainder interests, their father Bruce would have been deemed to have made a transfer of the trust’s remainder interest to them under IRC 2519(a). That would have triggered a gift tax liability for Bruce. Under IRC 2207A(b) Bruce would then have had a statutory right to recover that gift tax liability from his children, the deemed donees of his deemed gift. Accordingly, this gift tax recovery right held by Bruce would then have reduced the amount of Bruce’s deemed gift to his children, leading to an ‘interrelated computation’, which is practically identical to a *net gift* situation where the donees (Bruce’s children) assume Bruce’s gift tax liability under IRC 2519(a).

Competing Valuation Scenarios: Peter and Linda’s valuation expert witness provided the Court with three alternate valuation scenarios to consider:

- (i) In the first scenario, the children’s expert disregarded Bruce’s testamentary power of appointment, and his discretionary principal distribution right. The initial gross value of their respective remainder interests was \$53.21 million but then that amount was discounted for lack of marketability and lack of control discounts, which was then divided by 1.4 to reflect a *net gift* tax adjustment under IRC 2207A, which resulted in a value of each child’s remainder interest of \$36.6 million.
- (ii) In the second scenario, the expert factored in Bruce’s discretionary right to receive a principal distribution [valued at \$16.2] from the trust, which resulted in a net deemed gift value of \$34.9 million for each child,
- (iii) In the third scenario, the expert factored in Bruce’s limited testamentary power of appointment and thus concluded that Peter and Linda possessed

only a remote probability of receiving any cash flow from the trust, which resulted in a hypothetical value of \$156,000 each.

The IRS's valuation expert did not follow the discounted cashflow model. Instead, he used the 'subtraction method' to determine the value of the deemed gifted remainder interests. He subtracted the value of Bruce's QTIP income interest from the trust's net asset value (\$117,604,850), to reach the conclusion that the value of each child's gifted remainder interest in the trust was \$49,197,850.

Tax Court Valuation Decision: The Court found that the value of the deemed gift of the respective remainder interests by each of Peter and Linda to their father was \$35,141,321. Key points in the Court's valuation analysis in light of the arguments made were the following:

IRC 7520 is Inapplicable- State Property Law Prevails: Perhaps as the biggest surprise is that the Tax Court found that the IRC 7520 valuation tables did not apply to the valuation of the QTIP remainder interests. The IRS had argued that the nonjudicial settlement agreement converted the QTIP remainder interests to 'prototypical property interests' that had to be valued using IRC 7520. The children had argued that because of their father's testamentary limited power of appointment and his right to receive principal distributions, the remainders were 'restricted beneficial interests' that are exempt under IRC 7520. The Court found that while federal law governs taxation, it is state law that defines property rights. Therefore, Washington property law, not IRC 7520, governed the valuation. "*A trustee might look to section 7520 tables for guidance, but we do not agree that those tables would be determinative...we think not.*"

No Impact of Testamentary Limited Power of Appointment: Like most state common laws, Washington's is that the fiduciary has the paramount duty in construing Wills and trusts to give effect to the testator (or settlor's) intent. Because Bruce had exercised his limited power of appointment in his Will to leave the QTIP trust assets to his own revocable trust, the children's remainder interest was almost worthless, e.g., \$156,000. The Court noted that this possible scenario was "*manifestly contrary to the intent reflected in Clotide's Will....Had Clotide wanted to leave all her assets to Bruce she could easily have done so by bequeathing all her property to him free of trust, and her estate could still have*

utilized the marital deduction to defer transfer taxes until Bruce's death." Thus, Clotide apparent expressed the intent was that Bruce should not have outright ownership of the trust assets. The Court found that a Washington 'probate' court would have required the trustee to divide the trust assets equally on Bruce's death, effectively ignoring that he held a testamentary limited power of appointment. [It is not clear from the decision why the judge felt comfortable completely ignoring Bruce's legal ability to disinherit his children's interest in the trust.]

IRC 2207A Reimbursement Obligation Applies: While the IRS argued that this reimbursement obligation, i.e., the effect of being a *net gift*, was 'too speculative', the Tax Court found that the deemed gift by Linda and Peter had to be measured by what actually occurred against what they would have received under their mother's Will. If they had received their distributions from the QTIP trust, Bruce would have owed gift tax along with the right to recover that gift tax liability from his children. *"What Linda and Peter each gave up, therefore, is the distribution he or she would have received net of the avoided liability to reimburse Bruce for the gift tax."* Accordingly, the value of the deemed gift of their remainder interests had to be reduced under the *net gift* construct, dividing the pre-reimbursement remainder values by 1.4, which divisor reflects the maximum 40% marginal federal gift tax rate.

Bruce's Life Expectancy: The IRS's expert treated Bruce as being five years younger than his actuarial age of 85, due to his high income (\$2.2 million) and anecdotal testimony that he was in "good health and mentally sharp." The Tax Court rejected this age adjustment. *"Bruce's high income alone does not justify departing from the standard actuarial tables to determine his life expectancy."* In passing the judge noted that many other factors beyond wealth are reflected within the actuarial studies on which the IRC 7520 actuarial tables are based.

Conclusion: This is an interesting valuation decision, that helps, albeit somewhat, when attempting to value a deemed gift. The key points are: (i) state property laws control the value of the property interests and rights that are the subject of the transfer; and (ii) if a remainder interest in a QTIP is the subject of the transfer, the *net gift* result caused by IRC 2207A will reduce the value of the deemed gift of that remainder interest. That said, I am still not convinced that the judge was correct in blissfully ignoring the presence of Bruce's

testamentary power of appointment which could effectively eliminate the remainder's interest in the QTIP trust.

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