BESSEMER TRUST

# McDougall v. Commissioner, 163 T.C. No. 5 (September 17, 2024)

October 2024

**Early Termination of QTIP Trust; Spouse Did Not Make Gift of Remainder interest Under Section 2519; Children's Agreement That All Assets Passed to Spouse-Beneficiary Resulted in Gifts From Children to Spouse**

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## 1. Brief Synopsis

*McDougall* is a Tax Court case that involved planning for assets in a large (about $118 million) QTIP trust that had more than doubled since it was funded. The trust was created following a wife's death, requiring that all net income be distributed to the surviving husband (H) and allowing principal distributions to him in the trustee's discretion for his health, maintenance, and support. H held a testamentary power of appointment to appoint the assets to the deceased wife's descendants, and in default of exercise the remainder at H's death would pass equally to their children (or the descendants of a deceased child).

Five years after the trust was created, H, his two children ("Children") as remainder beneficiaries, and virtual representatives of the contingent remainder beneficiaries, entered into an agreement to have all the trust property distributed to H. On the same day, H transferred "substantially all" the trust assets to trusts for the Children and their descendants in return for secured promissory notes.

This case was addressed in CCA 202118008. The IRS concluded that (1) descendants made gifts to H of their remainder interest, (2) H made a gift of QTIP trust remainder interest under §2519, and (3) H used gift exclusion and would have notes from the sale included in his gross estate.

The Tax Court issued a reviewed opinion on September 17, 2024, deciding two issues raised in cross motions for summary judgment by the parties.

First, the court held that H did not make a gift of the remainder interest under §2519. Neither (1) the termination of the trust and distribution of all assets to H nor (2) the distribution of assets to H coupled with the sale of substantially all the assets to trusts in return for notes resulted in a gift under §2519. Relying on *Estate of Anenberg*, the court reasoned that it did not decide whether those events resulted in "disposition" of any part of H's qualified income interest that triggered §2519. Even assuming there was a disposition that triggered §2519, because H ended up with all the trust assets (or notes reflecting the value of the trust assets) he made no gratuitous transfer. (The *McDougall* majority opinion did not mention the alternative "incomplete gift" rationale discussed in *Estate of Anenberg*.)

Second, the court held that the Children made gifts to H by agreeing that all the trust assets could be distributed to H. *Estate of Anenberg* did not discuss whether the remainder beneficiaries made gifts by agreeing to have all assets distributed to the spouse, but the IRS did raise that issue in *McDougall*. The majority's reasoning to support its conclusion that the Children made gifts by agreeing that all assets could be distributed to H included the following.

- The "QTIP fiction" treating H as owning the property focuses on deferring, imposing, and collecting a single transfer tax, not on transactions that persons other than the spouse may take with respect to their own interests in QTIP.
- There are no "reciprocal gifts" between H and the Children because H is not treated as making a gift to the Children under §2519; furthermore, they already owned the remainder interests and a deemed transfer of remainder interests to them under §2519 "added nothing to their bundle of sticks."
- H's existing interest in the QTIP does not negate a gift by the Children; he was deemed to hold rights to the QTIP assets for purposes of determining *his* transfer tax liability, not whether others made gifts to him of their interests in the trust.
- The economic positions of the parties changed as a result of the distribution of all assets to H.

The court will determine the value of the Children's gifts to H in a later proceeding. The court specifically observed that "under the terms of [the wife's] will, [H] could have decided in his own will to reduce one of the children's shares significantly," and added in a footnote that "the import (if any) of these terms for the value of [the Children's] remainder rights remains to be decided."

A concurring opinion by Judge Halpern (who was the trial judge) reasoned that H did not dispose of a qualifying income interest in the property and therefore did not trigger §2519 (observing, among other

things, that a regulation analogously provides that a distribution of QTIP assets to the spouse under a power of appointment does not result in a disposition of the income interest by the spouse that triggers §2519 even if the spouse subsequently disposes of the appointed property.) Because H made no deemed transfer under §2519 to the Children, "their 'very real' transfers to him stand alone as taxable gifts."

*McDougall v. Commissioner*, 163 T.C. No. 5 (Sept. 17, 2024) (majority opinion by J. Toro, concurring opinion by J. Halpern).

## 2. Basic Facts

Husband (H) was the beneficiary of a QTIP trust created by his deceased wife, who died in 2011. The trust was funded with about $54 million, and five years later it had more than doubled to about $118 million. The trust required that all net income would be distributed to H and allowed principal distributions to H in the trustee's discretion to provide for H's "health, maintenance and support in his accustomed manner of living." H held a testamentary power of appointment to appoint the assets to the decedent-wife's descendants. To the extent the power of appointment was not exercised, the remainder would be divided following H's death "into equal shares, one share for each of [the wife's] children who is then living and one share for each of [her] children who is then deceased with descendants then living."

In 2016, H, his two Children as remainder beneficiaries, and virtual representatives of the contingent remainder beneficiaries, entered into a nonjudicial agreement to have all the trust property distributed to H. On the same day, H transferred "substantially all" the trust assets to trusts for the Children and their descendants as a sale in return for secured promissory notes.

Notices of Deficiency asserted that H made a gift of the remainder interest under §2519 equal to about $106.8 million and the Children made gifts in an equal amount back to H. H's gift tax deficiency was about $47.7 million and the Children's gift tax deficiency was about $43.4 million, resulting in total gift tax deficiencies of over $90 million. And H was left owning promissory notes equal to the value of the QTIP assets that would be subject to transfer tax in the future.

The IRS Chief Counsel's Office took the position in CCA 202118008 that: (1) the Children were treated as making gifts to H of their remainder interest; (2) H was treated as making a deemed gift under §2519 of the full value of the remainder interest; and (3) the gift/sale by H of the trust assets utilized his gift exclusion amount for a small gift and H would have the value of notes included in his estate for estate tax purposes. For a detailed discussion of CCA 202118008, see Item 8.h of Estate Planning Current Developments (March 16, 2022) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

The three gift tax cases involving H and each of the two Children were consolidated for trial. *McDougall v. Commissioner*, Docket Nos. 2458-22, 2459-22, and 2460-22 (Petitions filed February 18, 2022, Judge Halpern). (The taxpayers are represented by John Porter, Keri Brown, and Tyler Murray.) For a detailed description of the IRS's and taxpayers' arguments in the case, see Item 30 of Akers, Aucutt, and Nipp, *Estate Planning Current Development and Hot Topics* (December 31, 2023) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights.**

## 3. Majority Opinion Analysis

a. **No Gift of the Remainder Interest by H Under Section 2519; Analysis Relying on *Estate of Anenberg*.** The majority opinion summarized "lessons from *Estate of Anenberg*." *Estate of Anenberg v. Commissioner*, 162 T.C. No. 9 (May 20, 2024), addressed similar facts. It reasoned that the court did not need to decide if the spouse-beneficiary made a disposition of any part of the qualifying income interest that triggered a deemed transfer of the remainder interest under §2519. Even if it did, that only resulted in a deemed "transfer" of the remainder interest, but no gift resulted because the surviving spouse ended up actually owning all the assets unencumbered. "At the end of day, she gave away nothing of value as a result of the deemed transfer." *Estate of Anenberg v. Commissioner*, slip op. at 15.

The IRS in *McDougall* maintained that H made a deemed gift of the remainder interest under §2519(a) arguments: (1) as a result of "the implementation of the Nonjudicial Agreement"; or (2) by "the implementation of the Nonjudicial Agreement coupled with the subsequent sale of the trust property for promissory notes." The court rejected the IRS's position. Footnote 5 of the majority opinion in *McDougall* stated (similar to *Estate of Anenberg*) that the court did not decide whether a disposition of H's qualifying income interest occurred that triggered §2519. Even if it did, no gift of the remainder interest resulted "for the reasons we set out in *Estate of Anenberg*." *McDougall v. Commissioner*, slip op. at 11.

b. **Children Made Gifts.** The majority rejected various arguments by the taxpayers to support that the Children made no taxable gifts by agreeing that H could receive all the trust assets.

(1) **Scope of the QTIP Fiction.** Taxpayers argued that the QTIP fiction (treating the spouse as owning the QTIP) means "the children simply had nothing that they could give away." *Id.* at 13. The court observed that the QTIP fiction does not apply for all purposes (citing *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999)), but more importantly reasoned that the QTIP provisions focus on deferring transfer tax until the death of or gift by the surviving spouse. They focus on the transfer of marital assets outside the marital unit but "say nothing about, and do not apply to, transactions that transferees outside the marital unit, such as [the Children], may undertake with respect to their own interests in QTIP." *McDougall v. Commissioner*, slip op. at 13.

(2) **Reciprocal Gifts.** The taxpayers argued that H and the Children made reciprocal gifts that offset each other. However, the court's determination that H did not make a gift under §2519 meant that no reciprocal gifts could have occurred. Furthermore, the Children could not receive anything of value as a result of the nonjudicial agreement because "they already had the remainder rights" and a deemed transfer under §2519 "added nothing to their bundle of sticks." *Id.* at 14.

(3) **H's Existing Interest in the QTIP.** Taxpayers argued that while the Children may have interests under state law as trust remainder beneficiaries, H is treated as the owner of the assets for tax purposes under the fiction of the QTIP regime. How can one make a gift of an asset to a donee who already owns the asset for tax purposes? The court disagreed. "Any rights [H] may have been deemed to hold because of the QTIP fiction do not negate the very real interests [the Children] held …." *Id.* at 15. If the Children had transferred their rights to a third party, the transfers would clearly be a gift; that H was the recipient does not change this conclusion.

(4) **Economic Position of the Parties.** The taxpayers maintained that the economic positions of the parties were unchanged, but the court explained why the economic positions of the parties clearly changed. H did not own the assets outright before the trust termination but afterward he did. The Children owned remainder interests before the termination and afterward they did not. *Id.*

c. **Value of Children's Gifts.** The court will determine the value of the Children's gifts to H in a later proceeding. *Id.* at 12, n.7. The trustee could make discretionary principal distributions to H, and H held a testamentary power of appointment to appoint trust assets to the wife's descendants. The court specifically observed that "under the terms of [the wife's] will, [H] could have decided in his own will to reduce one of the children's shares significantly," *id.* at 15-16, and added in a footnote that "[t]he import (if any) of these terms for the value of [the Children's] remainder rights remains to be decided." *Id.* at 16, n.10. (Because the valuation issue is still pending, there is no final judgment, and periods to appeal the case are not running.)

### 4. Concurring Opinion Analysis

The fourteen-page majority opinion (ten pages of which discussed the legal issues) is followed by a thirteen-page concurring opinion by Judge Halpern (who is the trial judge) describing how he would analyze the case differently than the other thirteen judges to arrive at the conclusion that the Children made gifts by joining in the nonjudicial agreement terminating the trust and leaving all the trust assets to H.

a. **Adequate Consideration vs. Incomplete Transfer Rationale.** *Estate of Anenberg* discussed two alternate approaches for its conclusion that the surviving spouse did not make a gift of the remainder interest under §2519: (1) the spouse received adequate consideration offsetting the value of a deemed transfer of the remainder interest; or (2) the spouse's deemed transfer under §2519 resulted in an incomplete gift. The *Estate of Anenberg* opinion relied primarily on the adequate consideration rationale.

b. **That Approach Yields Incongruous Results in *McDougall*.** The issue in *McDougall* is whether the Children made gifts. The concurring opinion interprets the majority analysis as treating H as receiving adequate consideration for his deemed transfer of the remainder interest "but, from [the Children's] perspective, their transfers were wholly gratuitous and thus taxable gifts." *McDougall v. Commissioner*, slip op. at 21. Judge Halpern questions "whether the bounds of the QTIP fiction are so clearly delineated as to justify that differential treatment." *Id.*

c. **Scope of QTIP Fiction.** Section 2519(a) does not "expressly provide that the surviving spouse can be treated as having received consideration for a deemed transfer of interests" [the issue explored in the controversial *Kite II* order], and Judge Halpern asks how far the QTIP fiction can be extended beyond the express terms of the relevant statutory provisions. *Id.* at 22. After striking down what Judge Halpern perceives as several red herrings (reciprocal gift arguments and whether the *U.S. v. Grace* doctrine applies to perceived reciprocal gifts), the concurring opinion reasons that the majority justifies treating H but not the Children as receiving adequate consideration, in its "selective recognition of offsetting transfers by perceived limits on the scope of the QTIP fiction." *Id.* at 23. But Judge Halpern observes philosophically: "Transfers that, from [H's] perspective, were consideration paid *to him* should be viewed, from [the Children's] perspective, as consideration paid *by them*." *Id.* at 24 (emphasis in original). Judge Halpern believes that philosophical dichotomy could be avoided with an alternate analysis.

d. **Alternative Analysis Using Incomplete Gift Rationale**.

(1) **Following the Incomplete Gift Rationale.** If any deemed transfer was a wholly incomplete gift, "it cannot have provided adequate and full consideration to [the Children] for their transfers to him." *Id.* Judge Halpern believes the wholly incomplete gift analysis may "prove too much." *Id.* But it calls into question whether, because of the interests and control H had in and over the trust assets, "a disposition of [H's] qualifying income interest in the [trust] property occurred in the first instance." *Id.*

(2) **No Disposition Under §2519(a)**. That H relinquished his beneficial interest in the QTIP "trust" "is of no moment." *Id.* at 25. Section 2519(a)'s references to "any disposition of all or part of a qualifying income interest in property to which this section applies" is to the property for which a marital deduction was allowed–the property that funded the QTIP trust. The issue "is not whether [H] disposed of his interest in the *trust* but whether he disposed of his qualifying income interest in the *trust property*." *Id.* (emphasis added).

After the trust termination H may have relinquished his beneficial interest in the trust, but he "owned *all* the interests in the property." *Id.* (emphasis in original). While the termination of the trust may have terminated H's qualifying income interest in the property, he retained all interests he owned in the trust property before the termination (which included the right to all income) and also received additional rights (outright ownership). "Acceptance of additional rights to property that add to those previously owned cannot be viewed as a relinquishment of the previously owned rights." *Id.* at 26.

Accordingly, Judge Halpern concludes that the disposition of all the trust property to H "did not effect a disposition of his qualifying income interest in the trust property" under §2519(a). That is consistent with the policy of the QTIP regime because the property (or sales proceeds from the sale of the property as pointed out in footnote 4 of the concurring opinion) would be included in H's gross estate under §2033.

On the other hand, a commutation of the trust with H receiving only the value of the income interest "would have effected a disposition of [H's] qualifying income interest in the trust assets" because he "would have relinquished any interest in the trust assets distributed to [the Children]." *Id.* at 27.

Judge Halpern points out the analogy the taxpayers had noted to Reg. §25.2519-1(e), stating that "[t]he exercise … of a power to appoint [QTIP] to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property." The regulation further supports that the distribution of all trust assets to H did not result in a disposition triggering §2519 because "the distribution of all trust property to [H] had the same effect as the exercise of a power to appoint the [trust] property to [H]." *Id.* at 28.

e. **Conclusion**. If the distribution of all trust property to H pursuant to the nonjudicial agreement was not a deemed transfer under §2519(a) from H to the Children, "then, as the majority concludes, he made no taxable gifts to them, and their 'very real' transfers to him stand alone as taxable gifts." *Id.* at 29. Judge Halpern points out that, unlike the analysis in the majority opinion, this analysis "does not depend on treating a single exchange differently from the perspective of the transferors and the transferee …. Concluding that the implementation of the Nonjudicial Agreement did not effect a disposition of [H's] qualifying income interest provides a more straightforward justification for the conclusions that [H] did not make a taxable gift but [the Children] made taxable gifts to him." (The majority responded in footnote 11 at the end of the majority opinion that "the analytical path [the concurring opinion] offers is neither more straightforward nor sounder than the one we adopt.")

## 5. Observations

a. **Analysis Important for Growing Attacks by IRS on Transactions With QTIP Trusts**. The IRS has been attacking transactions involving QTIP trusts under §2519 with growing frequency. *Estate of Anenberg* and *McDougall* make clear that those attacks will be unsuccessful in situations where all QTIP assets are distributed to the spouse-beneficiary. The key to the §2519 analysis in both cases is that assets passing to the spouse-beneficiary can be applied to offset deemed transfers of the remainder interest under §2519, repudiating the result in *Kite II*. (*Kite I* and *Kite II* are discussed in Item 27.e(5) of Akers & Nipp, *Looking Ahead – Estate Planning in 2024, Current Development & Hot Topics* (October 2024) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.)

b. **Commutations**. That "offsetting transfer" analysis would not prevent a classic commutation of beneficial interests in a QTIP trust from resulting in a deemed gift under §2519. To the extent the spouse does not receive all the QTIP assets, the difference would be a gift (either of a portion of the income interest or, more likely, of the remainder interest under §2519). Judge Halpern's concurring opinion in *McDougall* specifically pointed out that §2519 could be triggered under a classic commutation of beneficial interests. The spouse would be treated as disposing of a qualifying income interest if the spouse does not receive all the trust assets on the early termination of the trust because the spouse "would have relinquished any interest in the trust assets distributed to" other beneficiaries. *McDougall v. Commissioner*, slip op. at 28.

c. **Step Transaction Analysis.** *Estate of Anenberg* did not address whether the combination of the distribution of all QTIP assets to the spouse followed by the sale of the assets would trigger §2519. That seemed to be the general approach of *Kite I* (finding that the combination of the distribution of all assets to the surviving wife followed by her sale of the assets for a deferred private annuity triggered §2519). The IRS did not make that step transaction argument in *Estate of Anenberg*, but it did in *McDougall*, and the court rejected the argument. Combining an early termination of QTIP assets entirely to the spouse with even an immediate sale of the assets by the spouse is safe from a step transaction attack in the Tax Court because of *McDougall*.

d. **QTIP Planning Considerations In Light of *Estate of Anenberg* and *McDougall***. Estate freezing strategies are helpful to minimize the growth in the QTIP assets that will ultimately be subject to transfer tax.

One alternative is for the trustee to enter the estate freezing transaction directly with the QTIP trust assets. This could be as simple as having the trust invest in fixed income portfolios and having other trusts for the family invest in more aggressive equity portfolios. The combined trust portfolios (presumably for the same beneficiaries) could represent an appropriately diversified portfolio. Fiduciary issues obviously should be considered. Beyond that, the QTIP trust might sell assets to other family trusts or entities that are not subject to the transfer tax in return for notes. If accomplished shortly after the first spouse's death, the basis adjustment under §1014 might mean that relatively little gain would be recognized on the sale.

Another alternative is to take steps to get the QTIP trust assets into the hands of the spouse-beneficiary so that person can enter into freezing transactions (gifts or sales). First, consider making principal distributions to the spouse in accordance with the distribution standards. If the goal would be to get more assets to the spouse than can be justified under the distribution standards, trust modification actions may be considered to get assets to the spouse-beneficiary. This could be a traditional commutation (with the spouse receiving the actuarial value of his or her interest in the trust) or be a complete distribution of trust assets to the spouse in an early termination (as was done in *Estate of Anenberg* and *McDougall*).

- A traditional commutation would not be covered by the rationale of the Tax Court in the *Estate of Anenberg* and *McDougall* cases and would run the risk that the spouse would be treated as making a gift of the full remainder interest in the trust under §2519.
- If the spouse receives all the assets (by agreement with the remainder beneficiaries), the spouse should avoid making a gift under §2519, but the remainder beneficiaries may be treated as making a gift of their interests in the trust to the spouse. The amount of the gift by each remainder beneficiary may be reduced because of contingencies (possible principal distributions to the spouse or possible exercises of powers of appointment appointing assets away from the particular beneficiary).

In drafting QTIP trusts to leave the flexibility of getting trust assets to the spouse-beneficiary, consider giving a third party a power of appointment to appoint assets to the spouse. Reg. §25.2519-1(e) ("[t]he exercise … of a power to appoint [QTIP] to the donee spouse is not treated as a disposition under section 2519, even though the donee spouse subsequently disposes of the appointed property"). If an existing trust does not include such a power of appointment, consider if the trust could be decanted to a trust that would add such a power of appointment. If such decanting is within the proper exercise of the trustee's discretion, the children should not be treated as making a gift because of the decanting.

If assets are moved into the hands of the spouse-beneficiary by the exercise of a power of appointment, that should avoid the possibility of the IRS arguing that the transaction should be treated as a gift from the remainder beneficiaries to the income beneficiary or as a purchase of the income beneficiary's interest by the remainder beneficiaries, resulting in a gain recognition transaction (discussed below).

If the goal is to do freeze planning with only part of the QTIP trust assets, first divide the QTIP trust proportionately into separate trusts. Do the freeze planning with one of the trusts, leaving the other trust untouched to avoid §2519 and gift issues. Many PLRs have allowed taxpayers to sever QTIP trusts in anticipation of this type of planning. *E.g.*, Letter Ruling 202146001.

Be forewarned that planning with large QTIP trusts is difficult. *See* Joy Miyasaki & Read Moore, *Estate Planning Strategies for QTIP Trusts: Do Good Things Come to Those Who Defer?*, AMERICAN COLLEGE OF TRUST & ESTATE COUNSEL 2023 ANNUAL MEETING (March 2023); Read Moore, Neil Kawashima & Joy Miyasaki, *Estate Planning for QTIP Trust Assets*, 44th U. MIAMI HECKERLING INST. ON EST. PLAN. ch. 12, ¶1202.3 (2010).

e. **Income Tax Consequences.** Apparently, the IRS did not take the position in either *Estate of Anenberg* or *McDougall* that the early termination of the QTIP trust resulted in an income taxable transaction between the income and remainder beneficiaries. The IRS views the early termination of trusts as income tax events. The remainder beneficiaries in Letter Rulings 201932001-201932010 were treated as having purchased the interests of the life beneficiary and the contingent remainder beneficiaries (and the life beneficiary had a zero basis in his interest under the uniform basis rules of §1001(e) so the total amount paid to the life beneficiary was capital gain). The remainder beneficiaries, as the deemed purchasers, do not pay tax on amounts **received** in the commutation (as the fictional purchasers, they are just receiving what is left in the trust after they have bought out everyone else), but they "realize gain or loss on the property exchanged." So, they recognize gain on the assets **paid out** to others less the amount of their uniform basis attributable to those assets. Massive income taxation can result, which could be totally avoided by not terminating the trust early. For a detailed discussion of the 2019 letter rulings and the income tax effects of early terminations of trusts, see Item 16 of Estate Planning Current Developments and Hot Topics (December 2020) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

   What the effect would be when the full trust value is paid to the income beneficiary of a QTIP trust is not clear. At least for income tax purposes, the remainder beneficiary may be treated as making a gift to the income beneficiary of the value of the remainder interest, which amount therefore would not be taxable income under §102(a). *See Commissioner v. Duberstein*, 363 U.S. 278, 284-286 (1960) ("detached and disinterested generosity"). Perhaps any deemed purchase by the remainder beneficiary would be limited to the value of the income interest.

f. **Valuation Issue.** The valuation issue is very interesting. Any particular remainder beneficiary has significant contingencies on actually receiving trust assets. How will the court value those contingencies? Collectively, all the remainder beneficiaries in *McDougall* were assured of receiving the trust assets (other than assets that might have been distributed to H under the trust distribution standard) because H's power of appointment was to appoint the assets to the deceased wife's descendants, and they happened to be the remainder beneficiaries. But H could cut off any particular remainder beneficiary's interest. How would each such remainder beneficiary's interest be valued under that contingency?

   The likelihood is that the valuation issue will be settled (most valuation disputes end up being settled), and we will never know how the court would have addressed the valuation issue.