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U.S. Tax Court: Valuation of taxable gifts resulting from trust termination is not reduced by reason of testamentary limited power of appointment

The U.S. Tax Court on July 20, 2026, held that the value of taxable gifts made upon the termination of a residuary trust must be determined by ignoring the possible exercise of a testamentary limited power of appointment, by looking to state law rather than the actuarial tables prescribed under section 7520, and by reducing the value for tax reimbursement obligations under section 2207A that would have otherwise applied.

The case is: *Lewis v. Commissioner; McDougall v. Commissioner,* T.C. Memo. 2026-58. Read the Tax Court's opinion.

Summary

Upon the decedent's death in 2011, the residuary of her estate passed to a marital trust in which her surviving spouse had an income interest and their two children had remainder interests. The surviving spouse also had a power to appoint trust assets, upon his death, to the decedent's descendants. A QTIP election was made on the decedent's estate tax return for property passing to the marital trust.

In 2016, the surviving spouse executed a will that exercised his testamentary power of appointment in favor of his revocable living trust, the assets of which passed to his descendants. Later in 2016, the surviving spouse and his children entered into an agreement under which the marital trust was commuted and all its assets were distributed to the surviving spouse, who then promptly sold some of the assets he received from the marital trust to other trusts established for the benefit of the children and their children, in exchange for promissory notes.

The surviving spouse and his children separately filed gift tax returns for 2016 and reported that those transactions resulted in offsetting reciprocal gifts and no gift tax.

The IRS examined the gift tax returns and issued a notice of deficiency to each of the surviving spouse and his children and determined that (1) the commutation of the marital trust resulted in gifts from the surviving spouse to his children under section 2519 and (2) the agreement resulted in gifts from the children to the surviving spouse of the remainder interests in the marital trust under section 2511.

The Tax Court held in *McDougall v. Commissioner*, 163 T.C. 112 (2024), that, assuming there was a transfer of property under section 2519 when the marital trust was commuted, the surviving spouse is not liable for gift tax under section 2501 because he made no gratuitous transfers, and the transfer of the marital trust property in exchange for promissory notes also did not result in gifts from him to his children. However, the agreement to commute the marital trust resulted in gifts to the surviving spouse by his children under section 2511 because it allowed the surviving spouse to receive trust assets that would otherwise have been distributed to the children. The court left open, however, the question of the values of those gifts.

The IRS claimed that the children each made a gift to the surviving spouse of $53,408,746, while the children claimed that each gift had a value of only $156,000. The IRS argued that the surviving spouse's testamentary limited power of appointment should have no bearing on the values of the children's gifts because such power was terminated at the time of the commutation. The children argued that a hypothetical purchaser of the remainder interests would have severely discounted the price to be paid for the interests because the purchaser would end up with nothing upon the surviving spouse's death unless the surviving spouse made a new will that did not exercise his limited power of appointment. The Tax Court agreed with the IRS that the power of appointment should not affect the value but disagreed as to why. The court focused on what would have been distributed to each party if the trust had terminated without the direction in the commutation agreement that all assets go to the surviving spouse and concluded that state law and the intent of the decedent as expressed in her will would govern. Since she did not intend for her husband to receive all of her assets outright, her children would necessarily have received their share of the assets upon early termination of the trust. Thus, the surviving spouse's power of appointment did not reduce the value of the gifts.

The IRS also argued that the values of the children's gifts must be determined under the actuarial tables prescribed under section 7520 to value remainder interests for federal tax purposes. The children argued that, because of the surviving spouse's limited power of appointment, the gifts (1) were "restricted beneficial interests" exempt from the tables under Treas. Reg. § 25.7520-3(b)(1)(ii), and (2) had only a nominal value. The Tax Court agreed with the children that the actuarial tables did not apply, but on the more fundamental legal ground that the value of the gifts must be determined under state law, not federal gift and estate tax rules. A trustee determining how to divide the assets of the trust upon the trust's termination would not be making that determination, in the first instance, for purposes of the Internal Revenue Code. Instead, the trustee would be determining the beneficiaries' entitlements to the trust property — a matter of state law. The court concluded that, although a trustee might look to the section 7520 tables for guidance, they would not be determinative. Thus, the values of the children's gifts need not be determined under the section 7520 tables.

The children also argued that the value of the gifts must be reduced by the children's avoided tax reimbursement obligations under section 2207A. If the children had received their state-law distributions upon termination, it would have triggered a section 2519 disposition of the surviving spouse's income interest, making the surviving spouse liable for gift tax. The surviving spouse would have then been entitled under section 2207A(b) to recover that tax from his children. By allowing the surviving spouse to receive all the assets, his children avoided this reimbursement obligation. The Tax Court agreed with the children that the gifts to the surviving spouse must be reduced by this avoided tax liability.

Finally, the children argued that in valuing the surviving spouse's income interest in the residuary trust, and thus the children's net gifts to the surviving spouse, the surviving spouse's life expectancy on the date of the trust termination should be increased by five years because of the surviving spouse's high level of income. The Tax Court rejected that argument, holding that the surviving spouse's high income alone did not justify departing from standard actuarial tables to determine his life expectancy.

After reaching the foregoing conclusions and taking into account the IRS's concession of a maximum value, the Tax Court held that each child made a gift of $35,141,321.

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