Unexpected Implications of Trust Modifications and Decanting: What You Need to Know

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When asked to explain the difference between a Revocable Trust Agreement and an Irrevocable Trust Agreement, the typical answer is to explain that a Revocable Trust Agreement can be modified or terminated by the Grantor, while an Irrevocable Trust Agreement generally cannot. To further back this up, it is common practice for Irrevocable Trust Agreements to contain provisions enforcing this concept by providing something close to: "The Grantor shall have no right to alter or amend the Trust Agreement in any way…"

Despite this, Florida law provides methods of modifying Irrevocable Trusts in certain circumstances. These materials and the accompanying presentation can be divided into three parts. The first part will summarize the base requirements and use cases for the four primary methods of irrevocable trust modification under Florida law. The second part will highlight and summarize caselaw demonstrating the potential consequences when the modification of any form of irrevocable trust is done improperly. The third part will highlight specific considerations when performing trust modifications to a Supplemental Needs Trust.

I. Uniform Trust Code.

A total of 36 states including Florida, adopted the Uniform Trust Code (UTC) as a model law for trust administration created by the Uniform Law Commission to unify and codify trust laws across the United States.[1] The UTC was designed in part to help standardize rules for trusts and

[1] https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d

has been considered a major success, with a majority of states having adopted it in some form.[2] The UTC generally encompasses a broad range of trust-related matters, including trust modifications, reformations, non-judicial settlements and termination of trusts as part of a consistent model framework. The UTC has also been supplemented by other uniform acts, such as the Uniform Trust Decanting Act and the Uniform Directed Trust Act.

II. The Toolbelt: Methods of Trust Modification Under Florida Law

Florida law generally provides four distinct methods of modifying an irrevocable trust: Judicial Modification, Non-Judicial Modification, Non-Judicial Settlement Agreements, Reformation, and Trust Decanting. In turn, each of these methods has its own distinct challenges and best use cases.

A. Judicial Modification

Judicial Modification of a trust is accomplished by petitioning a court of competent jurisdiction to make the necessary modifications detailed in the petition. If the modification falls within the court's authority at common law or under one of two statutory frameworks, the court generally has the authority to (i) amend specific terms of the trust, including terms governing distributions to beneficiaries or administrative provisions; (ii) terminate the trust in whole or in part; (iii) authorize trustee actions that are either not explicitly authorized or are prohibited under the terms of the trust; or (iv) prohibit the trustee from taking actions that are permitted or required under the terms of the trust.[3]

In addition to the common law right for courts to modify, amend, terminate, or revoke trusts, Florida law provides two primary statutory mechanisms for judicial modification of a trust.

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[2] *Id.*
[3] Fla. Stat. § 736.04113(2)(a)-(d)

First, Fla. Stat. § 736.04113 authorizes courts to modify irrevocable trusts when any one of the following conditions are met: (i) the purposes of the trust have been fulfilled or have become illegal, impossible, wasteful, or impracticable to fulfill; (ii) because of circumstances not anticipated by the grantor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust; or (iii) a material purpose of the trust no longer exists.[4]

Due to its requirements, judicial modifications under 736.04113 focus on circumstances where modification is necessary to better align the trust's administration with the Grantor's original intentions or to adapt to unforeseen circumstances that may significantly trust's original purpose. Courts may consider situations where the objectives of the trust have already been substantially achieved, rendering ongoing administration wasteful or impractical, or where compliance with the strict terms of the trust has become impracticable due to changes in circumstances. These changes could include economic developments, legal shifts, altered family dynamics, or other unforeseen factors that make strict adherence to the trust terms detrimental to the trust or its beneficiaries. In such scenarios, modification may rectify inefficiencies, such as reducing administrative costs or eliminating redundancies associated with fulfilling terms that no longer serve the trust's material purpose. Additionally, the court may evaluate whether trust assets are being utilized to their full potential or if the trust's provisions inadvertently result in excessive expenditures or depletion of resources over time. By exercising this authority, the court seeks to ensure that the trust operates in a manner that honors the grantor's objectives while responding to practical realities faced by beneficiaries.

[4] Fla. Stat. § 736.04113(1)(a)-(c)

By contrast, Fla. Stat. § 736.04115 provides a broader authority by authorizing courts to modify a trust if the terms of the trust are no longer in the best interests of the beneficiaries.[5] This method is particularly suited for cases where the continuation of a trust's original terms no longer adequately serve the financial, personal, or developmental needs of its beneficiaries or where changes in circumstances create imbalances in its application. Courts applying this statute aim to ensure that the trust functions effectively in light of present realities, placing the welfare of the beneficiaries at the forefront of their analysis.

It should be noted that Florida law on this topic is somewhat more detailed than some other states. Many states have adopted statutes that are significantly closer to the Uniform Trust Code, providing that "[t]he court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust."[6] Similar to Florida law, these statutes also include an instruction that any such modification must be made in accordance with the Grantor's testamentary purposes in creating the trust.[7]

While this statutory authority is broad, the court must still examine the underlying purposes of the trust and seek to align any modifications with those purposes. This process may include adjusting terms related to the timing or amount of distributions, administration guidelines, or other provisions that affect how the trust operates in practice. In doing so, the court aims to adapt the trust to better achieve its intended objectives while eliminating inefficiencies or inequities that have emerged over time.

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[5] Fla. Stat. § 736.04115(1)
[6] S.C. Code § 62-7-412(a); *see also,* N.C. Gen. Stat. § 36C-4-412(a); UNIF. TRUST CODE § 412 (UNIF. LAW COMM'N 2023)
[7] *Id.*

Petitions under this section can be an important tool for addressing situations where the trust's terms create preventable hardships or fail to adapt to evolving conditions, such as economic changes, family dynamics, or the specific needs of individual beneficiaries. By focusing on the best interests of the beneficiaries, this statute ensures that the trust remains relevant, efficient, and equitable, reflecting both the original goals of the grantor and the present-day realities faced by those the trust is designed to benefit.

It is additionally important to note that Florida law additionally preserves the court's authority under common law to modify trusts.[8] Under Florida common law, courts must allow modifications when the Grantor and all beneficiaries under the trust consent to the modification, regardless of whether the trust is irrevocable or if the trust's purposes are still relevant and active.[9] As this indicates, common law trust modifications require the grantor to be alive and requires that the Grantor and the beneficiaries of the trust to not be incapacitated, such that they can consent to a modification.[10]

This mechanism provides a flexible solution for such cases. By emphasizing consensus and mutual agreement among all interested parties to the trust, this common law rule serves as a valuable alternative in cases where statutory conditions for modification or termination cannot be satisfied.

Despite the flexibility and authority of judicial modifications, this method also has drawbacks, including the costs and hassle associated with opening a court proceeding in order to request modification, and the possibility that a probate judge will not agree with the requested

[8] Fla. Stat. § 736.04113(4); Fla. Stat. 736.04115(5)
[9] Peck v. Peck, 133 So. 3d 587 (Fla. 2d DCA 2014)
[10] Randall v. Randall, 60 F. Supp. 308 (S.D. Fla. 1944)

modifications even if the necessary statutory requirements are met. In such circumstances one should consider one of the alternative methods that do not require court involvement.

B. Non-Judicial Modification

The next option afforded by Florida law is Non-Judicial Modification under Fla. Stat. § 736.0412. This section allows for irrevocable trusts to be modified by unanimous agreement of the trustee of the trust and all of the qualified beneficiaries of the trust.[11] For reference, under the Florida Trust Code, a "qualified beneficiary" means any living beneficiary who is eligible to receive distributions from a trust, would be eligible if the interests of a current beneficiary terminated, or would be eligible to receive distributions if the trust terminated.[12] This definition essentially extends to all current beneficiaries and all living remainder beneficiaries of a trust.

The binding nature of a Non-Judicial Modification extends to beneficiaries whose interests are adequately represented under Fla. Stat. §§736.0301-736.0306 by another person who has consented to the modification. This includes situations where beneficiaries are either minors, incapacitated, unborn or unascertainable, and their interests are adequately represented by someone who has no conflict of interest regarding the trust modification.[13]

While the 736.0412 does not contain limitations on modification authority related to the purposes of the trust, as is the case for Judicial Modification, there are several timing and administrative limitations imposed by the statute. First, Non-Judicial Modification cannot occur while the Grantor of the trust is still alive.[14] Additionally, the statute does not apply to any trust created prior to January 1, 2001, or to certain trusts created after December 31, 2000, that must

[11] Fla. Stat. § 736.0412(1); *see also*, UNIF. TRUST CODE § 411 (UNIF. LAW COMM'N 2023)
[12] Fla. Stat. § 736.0103(19)
[13] *See* Fla. Stat. § 736.0304
[14] Fla. Stat. § 736.0412(1) (Stating that such modifications must occur "[A]fter the settlor's death…")

vest or terminate within the period prescribed by the rule against perpetuities, unless the terms of the trust expressly authorize Non-Judicial Modification.[15] Finally, the statute does not apply to any trust for which a charitable deduction is allowed under the Internal Revenue Code until the termination of all charitable interests in the trust.[16]

It is important to note that the authorization of Non-Judicial Modifications under Florida law may represent a deviation from the Uniform Trust Code, and it does not have a close equivalent in the Uniform Trust Code.

C. Non-Judicial Settlement Agreements

The third option afforded under Florida law is for the interested persons of an irrevocable trust (typically consisting of the Trustee(s) and/or qualified beneficiaries) to enter into a binding non-judicial settlement agreement under Fla. Stat. § 736.0111. Generally, interested persons may enter into these agreements with respect to any matter involving the trust. However, such agreements are subject to important limitations. A nonjudicial settlement agreement is valid only to the extent the terms and conditions could be properly approved by the court.[17] Additionally, a nonjudicial settlement agreement may not produce a result not authorized by other provisions of the Florida Trust Code, including terminating or modifying a trust in an impermissible manner.[18] Examples of matters that can be resolved through a nonjudicial settlement agreement include interpreting or construing trust terms, appointing or resigning trustees, and determining trustee compensation.[19]

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[15] Fla. Stat. § 736.0412(4)
[16] Fla. Stat. § 736.0412(4)(c)
[17] Fla. Stat. § 736.0111(3); *see,* S.C. Code § 62-7-111(c); N.C. Gen. Stat. § 36C-1-111(c); *see also* UNIF. TRUST CODE § 111(c) (UNIF. LAW COMM'N 2023)
[18] *Id.*
[19] Fla. Stat. § 736.0111(4); *see also* UNIF. TRUST CODE § 111(d) (UNIF. LAW COMM'N 2023)

Unlike Non-Judicial *Modifications*, Non-Judicial *Settlement Agreements* can address a much broader scope of trust-related matters beyond mere amendments to trust terms. Additionally, Sec. 736.0111 does not include limitations contained in Sec. 736.0412 related to trusts created before 2001. Moreover, Non-Judicial Settlement Agreements can be entered into regardless of whether the Grantor is still living.

Despite their broader scope, Non-Judicial Settlement Agreements typically cannot change actual terms of a trust. While some flexibility can be found in the authorization to interpret and construe the terms of a trust, it is important to keep in mind that this does not entail actually rewriting the terms of the trust. Instead, the interested persons can utilize these agreements to construe or clarify terms of a trust that may be ambiguous.

D. Reformation

Fla. Stat. § 736.0415 permits courts to reform trust to cure mistakes within the terms of the trust. Like a Judicial Modification, the process of reformation begins with a petition to the court, which may be filed by the Grantor or by any interested person. The petitioner must present evidence showing by clear and convincing evidence that both the settlor's intent and the trust's written terms were negatively affected by a mistake.[20] Such mistakes can arise from misunderstandings, incorrect assumptions, or clerical errors that result in provisions contrary to the Grantor's wishes. Importantly, the statute recognizes mistakes in both expression - such as drafting or typographical errors – and inducement, where factual or legal misjudgments underpinned the creation of the trust terms, and reformation may be employed to cure scrivener's

[20] Fla. Stat. § 736.0415; *see also*, UNIF. TRUST CODE § 415 (UNIF. LAW COMM'N 2023)

errors within the trust agreement.[21] One additional potential use of Judicial Reformation of a trust is as a curative measure when a trust has been modified improperly.[22]

It is important to note that Florida law permits reformation of trusts even after the Grantor's death under certain circumstances. For example, a trust with testamentary aspects may be reformed after the death of the Grantor for a unilateral drafting mistake so long as the reformation is not contrary to the interest of the Grantor.[23]

While this approach can work for fixing clear errors in the drafting of the trust agreement. It cannot be used as a justification for the modification of trust terms to account for changes in circumstance such as significant changes in the financial circumstances of the Grantor between the time when the trust was executed and the time of the Grantor's death.[24] For such circumstances, a different method, such as Judicial Modification would be necessary.

E. Trust Decanting

Finally, Fla. Stat. § 736.04117 authorizes an authorized Trustee to decant the trust by appointing all or part of the principal to the trustee of a new trust.[25] Under the statute, the authorized trustee who has the authority to decant the trust must not be the Grantor or a beneficiary under the original trust, and must have the power to invade the principal of the original trust.[26]

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[21] Reid v. Temple of Judea, 994 So. 2d 1146, at 1150 (Fla. 3d DCA 2008) (quoting Fla. S. Comm. On Banking & Ins., CS for SB 1170 (2006) Staff Analysis 20 (March 21, 2006))
[22] *See* Berger v. United States, 487 F. Supp. 49 (W.D. Pa. 1980)
[23] *See* Megiel-Rollo v. Megiel, 162 So. 3d 1088 (Fla. 2d DCA 2015)
[24] Morey v. Everbank, 93 So. 3d 482, at 491 (Fla. 1st DCA 2012)
[25] Fla. Stat. § 736.04117(2)(a); *see also*, UNIF. TRUST DECANTING ACT § 11 (UNIF. LAW COMM'N 2015)
[26] *Id.*

Another important restriction on decanting is that the beneficiaries of the new trust must include only beneficiaries of the original trust.[27] Additionally, the new trust cannot reduce any beneficiaries vested interest in the trust property from the original trust.[28]

Procedurally, the Florida statutes mandate strict requirements when decanting a trust. Trustees must provide written notice to all qualified beneficiaries, the Grantor in certain situations, any other Trustees, and any individual with the power to remove or replace the authorized Trustee of the original trust at least 60 days before exercising to power to decant.[29] The Trustee must also provide copies both of the original trust instrument, as well as the proposed instrument for the replacement trust.[30] The beneficiaries have the opportunity to waive the notice period.[31] Otherwise, the beneficiaries have the opportunity to object to the decanting during the 60 day notice period. If no objections are made, and the authorized Trustee complies with the other statutory requirements, the decanting process may proceed.

While Florida law provides significant flexibility, it also allows the terms of the trust agreement to expressly prohibit decanting.[32] If the original trust document explicitly states that decanting is forbidden, the trustee must abide by this provision and cannot exercise powers to transfer assets to the new trust. Such prohibitions serve as Grantor-imposed limits on trustee authority and must be strictly observed. Where no such prohibition exists, trustees may proceed with decanting provided that the decanting meets the statutory requirements outlined above.

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[27] *Id.*
[28] *Id.*
[29] Fla. Stat § 736.04117(8)(a); *see also* UNIF. TRUST DECANTING ACT § 11(c) (UNIF. LAW COMM'N 2015)
[30] Fla. Stat § 736.04117(8)(b); *see also* UNIF. TRUST DECANTING ACT § 11(e) (UNIF. LAW COMM'N 2015)
[31] Fla. Stat § 736.04117(8)(c)
[32] Fla. Stat. § 736.04117(2)(a)

III. Consequences of Improper Modification of Trusts

When utilizing any of the forms of trust modification outlined above, one must always start by determining the Grantor's purposes and intent when the trust was formed. Additionally, an attorney modifying a trust must determine (i) that the modification will not violate any of the statutory requirements associated with the type of modification that will be utilized; and (ii) that the subsequent actions of the interested parties will not result in adverse tax consequences. The most basic consequence of an improper trust modification would be the invalidation of the modification.

A. Harrell v. Badger, and Special Considerations for Special Needs Trusts

The Case of *Harrell v. Badger* is instructive on two fronts: first, as an example of an invalidating trust decanting, and second for its relation to Special Needs Trusts. The story of this case begins when Rita Wilson established a trust under her Last Will and Testament for the sole benefit of her adopted son, David Wilson.[33] Under the terms of the Trust, the Trustee was instructed to pay all of the trust income to David on a monthly basis, and the Trustee was given discretion to make additional payments of the trust principal to David under an ascertainable standard.[34] Upon David's death, the remaining trust assets were to be distributed to Rita's daughters.[35]

At a time after Rita's death, the Trustee of David's Trust attempted to decant the trust into a Special Needs Trust to qualify David for government benefits.[36] To accomplish this the Trustee joined David's Trust as a subtrust under a pooled special needs trust entitled the Florida Foundation for Special Needs Trust.[37] In accomplishing this change, the Trustee made two errors. First, the Trustee did not provide notice to Rita's daughters, as the remainder beneficiaries, of his intent to

[33] Harrell v. Badger, 171 So. 3d 764, at 766 (Fla. Dist. Ct. App. 2015)
[34] *Id.*
[35] *Id.*
[36] *Id.* at 767
[37] *Id*.

invade the principal of the trust under Fla. Stat. § 736.04117.[38] The second error came from the terms of the decanted trust. Under the decanted trust, provided that, upon David's death, his trust would be dissolved and any remaining assets would be absorbed into the Florida Foundation for Special Needs Trust.[39]

The court determined that this fact pattern first presented a violation of Fla. Stat. § 736.04117(2)(a), requiring the beneficiaries of the successor trust to include only beneficiaries under the original trust, and a violation of Fla. Stat. § 736.04117(8), requiring notice to be provided to all qualified beneficiaries of the original trust.[40] As a result of these statutory violations, the Court ordered that the decanting be reversed, and that all remaining assets be returned to the original trust.[41]

The *Harrell* case demonstrates the most basic concept that one must actually follow the statutory requirements for a given modification as provided under Florida law. Additionally, it presents a particular warning for practitioners who intend to either decant a non-qualifying trust into a Special Needs Trust or to decant a Special Needs Trust into a non-Special Needs Trust. At its base, this case demonstrates basic consequences stemming from failure to meet the statutory requirements for modification. However, recent federal caselaw further demonstrates that unintended consequences can result, even when a modification is successful and the statutory requirements are met.

IV. Anenberg and McDougall: Tax Considerations Post Modification

[38] Harrell, 171 So. 3d at 769
[39] *Id.*
[40] *Id.*
[41] *Id.*

Last year, the United States Tax Court released two opinions involving the termination of marital trusts holding certain terminable interests and the subsequent sale of assets held under marital trusts prior to termination. The two relevant cases, *Estate of Sally J. Anenberg v. Commissioner* and *McDougall v. Commissioner*, have extremely similar fact patterns, but resulted in seemingly different rulings. Consequently, they should be analyzed together to better understand the potential consequences and implications moving forward.

A. QTIP Elections and Gifts Under § 2519

As a preliminary matter, to better understand the results of the *Anenberg* and *McDougal* cases, we must first provide a foundation regarding the laws surrounding Qualified Terminable Interest Property ("QTIP") trusts and the corresponding tax laws. In general, when the first spouse of a married couple dies, the Internal Revenue Service provides an unlimited marital deduction on gift and estate tax for transfers to the surviving spouse.[42] It does not necessarily eliminate estate tax liability, but it does operate to defer the potential payment of estate tax until the death of the surviving spouse if estate taxes are owed for that estate. In general, transfers to the surviving spouse must grant the surviving spouse an absolute ownership interest in the assets transferred. This means that so-called "terminable interests," such as life estates, typically will not qualify for QTIP status.[43]

However, gifts of terminable interests can still qualify for the marital deduction if they are gifts of "qualified terminable interest property" ("QTIP property").[44] In order for such terminable interests to be recognized as QTIP property, they must first be transferred to the spouse in such a

[42] *See* IRC § 2523(a) (for the marital deduction from gift tax); and IRC § 2056(a) (for the marital deduction from estate tax)
[43] IRC § 2523(b); IRC § 2056(b)(1)
[44] IRC § 2523(f)(1); IRC § 2056(b)(7)(A)

way that the surviving spouse retains a qualifying income interest for life. Additionally, the decedent spouse's personal representative must make an election on the decedent spouse's estate tax return for the property to be treated as marital QTIP property under Schedule M.[45]

In practice, transfers of QTIP property are typically accomplished by forming a marital trust for the sole benefit of the surviving spouse upon the decedent spouse's death. In order to ensure qualification, the marital trust's terms must provide for mandatory distributions of all trust income to the surviving spouse at least annually. At the surviving spouse's death, the remaining assets of the marital trust will be distributed to the beneficiaries selected by the decedent spouse.

Potential issues arise if the surviving spouse attempts to gift all or part of his or her qualifying income interest to a different beneficiary. In that instance, the tax laws generally provide that any such disposition will not be treated as a disposition of the income interest; but will instead be characterized as a disposition of 100% of the remainder interests in the QTIP property.[46] With these general rules in mind, we can now revisit the *Anenberg* and *McDougall* cases.

B. Estate of Anenberg v. Commissioner

The essence of this case begins with Alvin and Sally Annenberg, a married couple who owned an oil company, and Alvin's two children from a prior marriage, Steven and Neil.[47]

In 1987 Alvin and Sally formed a revocable trust and funded it with 100% of the shares of the oil company.[48] Their trust provided for the creation of two marital trusts upon first death, and the terms of the trust gave the Trustee discretion to make a QTIP election with regard to the property held in the marital trusts. The marital trusts provided the surviving spouse with the requisite

[45] IRC § 2523(f)(2); IRC § 2056(b)(7)(B)(i)
[46] IRC § 2519
[47] Est. of Anenberg v. Commissioner, 162 T.C. 199, at 202 (2024)
[48] *Id.* at 203

qualifying income interest for life, and provided that the marital trust property would pass to trusts for the benefit of Alvin's children and descendants.

In 2008, Alvin died, and roughly half of the shares in the oil company passed to the marital trusts for Sally's benefit.[49] On Alvin's estate tax return, the personal representative of his estate made the requisite QTIP elections, and the marital deduction was applied.[50]

In 2011, Steven, the Trustee of the marital trusts, filed a petition to terminate the marital trusts, and to distribute all of the remaining property to Sally outright. The trust beneficiaries all signed consents to the petition, as required under state law, and the court granted the petition in 2012.[51]

Subsequent to the termination of the marital trusts, Sally gifted a portion of the oil company stock that had previously been held under the marital trusts to new trusts established for Alvin's children.[52] A month later, she sold the remainder of the shares to various trusts established for Alvin's descendants in exchange for promissory notes bearing annual interest at the applicable federal rate.[53] Additionally, Sally reported the gifted stock on a timely filed gift tax return, but excluded the sold shares under the position that the promissory notes represented adequate consideration for their sale.[54] In 2016, Sally died, and the IRS determined that her estate was liable for a gift tax deficiency of over $9 million resulting from the termination of the marital trusts and the subsequent disposition of the oil company shares, along with an accuracy-related penalty of over $1.8 million.[55]

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[49] *Id.*
[50] *Id.*
[51] *Id.* at 204
[52] Est. of Annenberg, 162 T.C. at 204
[53] *Id.* at 205
[54] *Id.*
[55] *Id.*

In assessing these penalties, the IRS took the position that IRC § 2519 applied either when the marital trusts were terminated or when the subsequent installment sales took place.[56] However, the Tax Court rejected the IRS's position due to the structure of the transactions. The Court reasoned that, in order for IRC § 2519 to apply and trigger gift tax, the relinquishment of the QTIP property would have to be in favor of someone other than Sally. Thus, because Sally was the beneficiary of the marital trusts, and because all of the property was distributed to Sally when the marital trusts were terminated, no gift tax was triggered.[57]

Next, the Court concluded that IRC § 2519 did not apply to the subsequent installment sales and gifts of the (formerly) marital trust assets. The Court reasoned that, after the termination of the marital trusts, the marital trust property ceased to be QTIP property and Sally became the absolute owner of the property.[58] In essence, this means that the Court interpreted 2519 to require Sally to transfer the marital trust property to Alvin's children immediately upon the termination of the trust in order to apply. Notably, because the IRS did not make the argument in the *Anenberg* case, the Court did not consider an alternate possibility of whether Alvin's children could be deemed to make a gift to Sally by consenting to the termination of the marital trusts. Instead, this issue would be left for a subsequent case described in further detail below.

C. McDougall v. Commissioner

The facts of the McDougall case are very similar to those discussed in the *Estate of Anenberg*. Cotilde McDougall died in 2011, and under her Last Will and Testament, her residuary estate

[56] *Id.*
[57] Est. of Annenberg, 162 T.C. at 216
[58] *Id.* at 217-218

passed to a trust for the benefit of her husband, Bruce.[59] The terms of the residuary trust provided that all income was to be distributed to Bruce annually, and provided for discretionary distributions of principal to Bruce under an ascertainable standard.[60] Upon the termination of a trust, Cotilde's Will provided that any remaining trust assets were to be distributed to the beneficiary entitled to receive distributions.[61] As was the case in Estate of Anenberg, a QTIP election was made on Cotilde's estate tax return.[62]

By 2016, the trust assets had appreciated significantly, and Bruce and Cotilde's children agreed that the assets would be better utilized outside of the trust.[63] To accomplish this, they entered into a non-judicial settlement agreement, providing that the residuary trust would terminate and all remaining trust assets would be distributed to Bruce outright.[64] On the date of the non-judicial settlement agreement, Bruce sold the assets to trusts for the benefit of the children in exchange for promissory notes.[65]

Interestingly, the parties in McDougall took a different approach when filing gift tax returns. Each of Bruce and the children filed gift tax returns, where they each took the position that the termination of the residuary trust did result in a deemed gift by Bruce under 2519. However, they argued that because the children joined in the non-judicial settlement agreement, the children made offsetting gifts of their remainder interests to Bruce.[66] Because of this, they argued that no taxable gifts resulted from the termination. As was the case in *Estate of Annenberg*, the IRS disputed this

[59] McDougall v. Commissioner, 163 T.C. No.5, at 2-3 (2024)
[60] *Id.*
[61] *Id.* at 3-4
[62] *Id.* at 4
[63] *Id.*
[64] *Id.*
[65] McDougall, 163 T.C. No.5, at 5
[66] *Id.* at 5-6

position and issued notices of deficiency to Bruce and the children.[67] However, unlike Estate of Annenberg, in this case the Tax Court did find that gift tax liability was triggered.

The difference in these rulings can be boiled down to the fact that the issue was raised in Bruce and the children's gift tax returns as to whether the children made gifts of their remainder interests when they agreed to the termination of the residuary trust. The Court actually maintained its ruling from Estate of Annenberg, concluding that Bruce did not make a gift to the children when the trust was terminated.[68] This was because Bruce received all of the trust property upon termination. However, the Court then then determined that the children had made taxable gifts by consenting to the termination of the residuary trust in exchange for no consideration.[69] Because of this, the Court concluded that the children were subject to gift tax under IRC §§ 2501 and 2511.

V. Modification of Supplemental Needs Trusts

Utilization of any of the five trust modification methods outlined above in the context of special needs trusts requires careful consideration of the potential effects such changes could have on the trust's ability to continue to qualify as a special needs trust.

Special Needs Trusts must satisfy specific federal requirements under 42 U.S.C.S. § 1396p(d)(4)(A). These trusts are required: "(1) to benefit a disabled individual who is under 65 years of age; (2) to contain this beneficiary's assets; (3) to have been established for the beneficiary by a parent, grandparent, guardian, or court; and (4) to give the state the amount left in the trust when the beneficiary dies, up to the amount of total medical assistance paid by the state."[70]

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[67] *Id.* at 8
[68] *Id*. at 22
[69] *Id*.
[70] *Sai Kwan Wong v. Daines*, 582 F. Supp. 2d 475, at 481 (S.D.N.Y. 2008); *see also* 42 U.S.C § 1396p(d)(4)

To this end, special care must be exercised in making modifications to ensure that the trust's qualification as a Special Needs Trust will not be jeopardized. Additionally, one must also ensure that the statutory requirements for the given form of trust modification are strictly followed.

VI. Conclusion

The conclusion one can reach from the statutory rules and case law regarding modifications to irrevocable trusts is that nothing is set in stone… except for stone. When employing any of the statutory tools provided to modify a trust, the practitioner must always keep a firm grounding in the Grantor's purposes in creating the trust. To the extent that a modification is needed to better effectuate that intent, the statutes provide options to accomplish this. However, all of these tools must adhere to appropriate procedural requirements and limitations as set forth in the statutes authorizing their use. Additionally, trust modifications should only be employed after rigorous consideration of the potential tax consequences resulting therefrom.