

Issues to Consider in Nonjudicial Settlement of Fiduciary Disputes

By Jarriot L. Rook and Douglas J. Stanley

Regardless of the amount of planning and foresight that is put into the preparation of estate planning documents, no one can ever fully anticipate the changes that can occur after estate planning documents have been executed. Circumstances change over the course of twenty years or longer; including changes to tax laws, relationships, and family dynamics, many of which are difficult or impossible to predict. Changing circumstances can lead to disputes among beneficiaries or among beneficiaries and trustees. Fortunately, the Missouri Uniform Trust Code ("MUTC") provides several options for resolving fiduciary disputes either privately among the parties, or by a court action. However, careful attention must be taken in deciding which course of action to take. In this article, our focus is on documenting the resolution of disputes privately without court involvement, and some of the tax consequences that can arise from such transactions.

Nonjudicial Settlement Agreements

The MUTC authorizes interested persons to privately enter into a binding nonjudicial settlement agreement with respect to certain matters involving a trust; however, such an agreement is valid only to the extent that it does not violate a material purpose of the trust and includes terms that could otherwise be properly approved by a court.¹ To be valid and binding, all interested persons who are parties to the nonjudicial settlement agreement must be adequately represented.

(1) Who Are the Interested Persons?

The term "interested persons" is defined by the MUTC as "persons whose consent would be required in order to achieve a binding settlement were the settlement to be approved by the court"² and "includes beneficiaries and any others having a property right in or claim against a trust estate which may be affected by a judicial proceeding. It also includes fiduciaries and other persons representing interested persons."³ The term "beneficiary" is defined by the MUTC as any person that (1) "has a present or future beneficial interest in a trust, vested or contingent" or (2) "in a capacity other than that of trustee, holds a power of appointment over trust property."⁴ Accordingly, the current trustees and all current and future beneficiaries of the trust must be adequately repre-

sented and thus must either directly consent to and sign the nonjudicial settlement agreement or be bound by virtual representation to ensure its validity and bind all parties to the agreement.

While obtaining the consent and signature of each beneficiary may seem innocuous on the surface, it can become tricky in cases when there are minor children or when an adult beneficiary is incapacitated. The virtual representation statutes found in Article 3 of the MUTC provide the rules for obtaining the proper representation of minor, unborn, or incapacitated beneficiaries.⁵ Unless in the unlikely event the trust instrument includes a procedure for substituted representation or substituted consent, then the Article 3 virtual representation statutes are the default law.

A person other than the interested party may represent and bind an in-

1. Mo. Rev. Stat. §§ 456.1-111(1) - (3).

2. Mo. Rev. Stat. § 456.1-111(3).

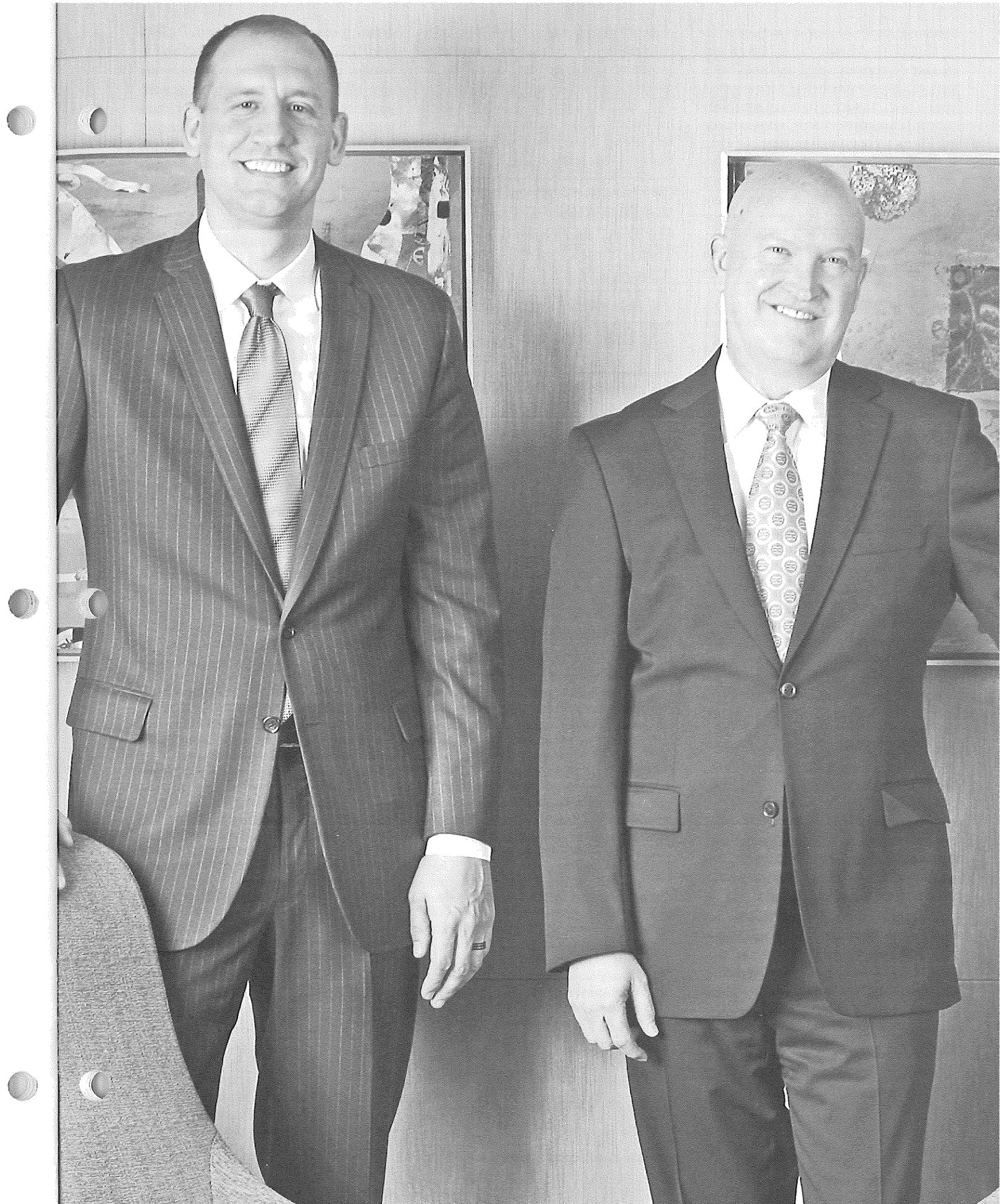
3. Mo. Rev. Stat. § 456.1-103(10).

4. Mo. Rev. Stat. § 456.1-103(3).

5. Mo. Rev. Stat. §§ 456.3-301 - 456.3-305.

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interested party if the representative is (1) the holder of a testamentary power of appointment and the interests of the person being represented are subject to such power of appointment; (2) a conservator, conservator ad litem, or a guardian representing a disabled individual; or (3) a parent representing his or her minor or unborn children.⁶ A parent may represent and bind his or her minor or unborn children if a conservator, conservator ad litem, or guardian has not been appointed for any such children, as long as there is no conflict of interest between the parent and the children.⁷

However, there is a way for a qualified beneficiary⁸ to represent and bind beneficiaries who are not qualified beneficiaries.⁹ A beneficiary who is not a qualified beneficiary (but is still an interested party) may be represented by and bound by a qualified beneficiary having a substantially identical interest with respect to the particular question or dispute, but only to the extent there is no conflict of interest with respect to the particular question or dispute between the qualified beneficiary and the person represented.¹⁰ This representation rule will apply only in proceedings under Mo. Rev. Stat. § 456.4-412(2) (which is the provision allowing the court to modify management or administration terms of a trust if the modification furthers the purposes of the trust) or in a nonjudicial settlement agreement.¹¹ Also, a minor, incapacitated or unborn individual or person whose identity or location is unknown or not reasonably ascertainable may be represented or bound by another person having a substantially identical interest with respect to the particular question or dispute.¹²

If a conflict of interest exists between all possible representatives and the beneficiary, the court can appoint a representative to consent to the nonjudicial settlement agreement on behalf of the beneficiary.¹³

If a charitable beneficiary is a qualified beneficiary of a trust, the Missouri Attorney General represents such organization and is a party to the nonjudicial settlement agreement.¹⁴

The failure to obtain a beneficiary's consent or to adequately represent

a beneficiary means that the non-consenting or unrepresented beneficiary will not be bound by the nonjudicial settlement agreement and will have the ability to later contest the terms of the agreement, thereby reopening a dispute that the parties thought was settled.

(2) Does the Agreement Violate a Material Purpose of the Trust and Does it Include Terms That Could Be Properly Approved by a Court?

A nonjudicial settlement agreement cannot make changes to the trust instrument that violate a ma-

terial purpose of the trust.¹⁵ The MUTC does not expressly define the term "material purpose", however the MUTC does provide that a nonjudicial settlement agreement cannot be used to terminate or modify a trust for the reasons that a court could terminate or modify a trust under Mo. Rev. Stat. § 456.4B-411,¹⁶ which provides that when all the adult beneficiaries having the capacity to contract consent, and when the court finds that the interest of any non-consenting beneficiaries will be adequately protected, the court has the authority to modify a trust (i) to reduce or eliminate the interest of some beneficiaries and increase

6. Mo. Rev. Stat. § 456.3-301(2).
7. Mo. Rev. Stat. § 456.3-303(4); where possible, to avoid any conflicts of interest, the preference is for a parent without a beneficial interest in the trust to represent and bind minor or unborn children to eliminate any concerns of a potential conflict of interest in the representation.
8. Mo. Rev. Stat. § 456.1-103(20) defines "qualified beneficiary" as a "beneficiary who, on the date of the beneficiary's qualification is determined: (a) is a permissible distributee; (b) would be a permissible distributee if the interests of the permissible distributees described in paragraph (a) of the subdivision terminated on that date; or (c) would be a permissible distributee if the trust terminated on that date." In turn, the term "permissible beneficiary" is defined by Mo. Rev. Stat. § 456.1-103(15) as "a beneficiary who is currently eligible to receive distributions of trust income or principal, whether mandatory or discretionary."
9. Mo. Rev. Stat. § 456.3-304(2).
10. If any interested person has a concern about the validity of the nonjudicial settlement agreement, pursuant to Mo. Rev. Stat. § 456.1-111(5), the interested person can ask that the nonjudicial settlement agreement be approved by the court, (i) to determine whether the representation as provided in Mo. Rev. Stat. §§ 456.3-301 to 456.3-305 is adequate; and (ii) to determine whether the agreement contains terms and conditions the court could have properly approved. If the parties choose to go a step further and ask the court to approve the actual action or decision or issue for which the nonjudicial settlement agreement is being entered into, then the agreement would most likely no longer be a nonjudicial settlement under Mo. Rev. Stat. § 456.1-111, and the parties would then have to follow the appropriate procedures for otherwise obtaining court approval. When the court is asked to approve the substance of the settlement so that it is no longer a "nonjudicial" settlement, the representation rule of Mo. Rev. Stat. § 456.3-304(2), which allows beneficiaries who are not qualified beneficiaries to be represented and bound by a qualified beneficiary having a substantially identical interest with respect to the particular question or dispute, would most likely no longer apply. In that case, all beneficiaries (e.g., those more remote than qualified beneficiaries) would have to be joined and provide their consent.
11. As a practical matter, if requesting a court to approve the actual modifications set forth in the nonjudicial settlement agreement, then the court will most likely not allow this form of virtual representation and all beneficiaries (including charitable organizations) who are not otherwise qualified beneficiaries will have to participate in the action either directly or by the virtual representation statutes under Mo. Rev. Stat. §§ 456.3-301 – 456.3-305, other than Mo. Rev. Stat. § 456.3-304(2).
12. Mo. Rev. Stat. § 456.3-304(1).
13. Mo. Rev. Stat. § 456.3-305.
14. Mo. Rev. Stat. § 456.1-110(2).
15. Mo. Rev. Stat. § 456.1-111(3).
16. Mo. Rev. Stat. § 456.1-111(6).

those of others, (ii) to change the times or amounts of payments and distributions to beneficiaries, or (iii) to provide for termination of the trust at a time earlier or later than that specified by its terms.¹⁷ All of these reasons for which a court can terminate or modify a trust would be deemed to be material purposes of the trust for which a nonjudicial settlement agreement could not be used. In addition, material purposes of the trust can be determined based upon the settlor's intent as outlined by the terms of the trust instrument. The settlor's intent may be explicitly stated within the terms of the trust or it may be necessary to infer the settlor's intent based upon the provisions of the trust.¹⁸

Alternatively, the MUTC lists some of the matters that can be resolved by using a nonjudicial settlement agreement, such as (1) the interpretation or construction of the terms of the trust, (2) the approval of a trustee's report or accounting, (3) granting the trustee the authority to act in a certain manner, (4) the resignation or appointment of a trustee, or (5) the liability of a trustee for acting in the name of the trust.¹⁹ The MUTC list is not meant to be exhaustive, and as such, there can be other matters that may not be material purposes and thus could be

17. Mo. Rev. Stat. § 456.4B-411(1).
18. As a planning point, when drafting, if there is a trust provision that the settlor deems to be a material purpose of the trust which the settlor would not want to have changed with a nonjudicial settlement agreement, then the settlor's trust should explicitly state the intention that such provision is a material purpose of the trust. Including a statement of the settlor's intention limits the ability of the beneficiaries to modify certain trust provisions via use of a nonjudicial settlement agreement.
19. Mo. Rev. Stat. § 456.1-111(4).
20. As with obtaining a court's approval as to whether all interested parties have been adequately represented, Mo. Rev. Stat. § 456.1-111(5) provides that the fiduciary or any interested person can ask the court to confirm that the nonjudicial settlement agreement contains terms and conditions that could have been properly approved by a court.
21. Mo. Rev. Stat. § 456.4A-411(1).
22. Mo. Rev. Stat. § 456.4A-411(2).
23. Mo. Rev. Stat. § 456.4A-411(1). In resolving a dispute with a nonjudicial modification agreement, the parties may decide to have a court approve the modification agreement. As of this writing, the standards for court-approved modifications or terminations of trusts that became irrevocable prior to January 1, 2005 are found under Mo. Rev. Stat. § 456.590, as opposed to Mo. Rev. Stat. § 456.4B-411 for trusts that become irrevocable after that date.
24. *Id.*

resolved by a nonjudicial settlement agreement.

When using a nonjudicial settlement agreement, it is important to make sure the terms of the agreement are not beyond the scope of matters allowed to be settled under the MUTC. If the parties attempt to enter into a nonjudicial settlement agreement the terms of which are beyond the scope of what is provided under the MUTC, then the agreement will be invalid and will have no binding effect on the parties involved.²⁰

Nonjudicial Modification Agreement

When the settlor of a trust is still living and is willing to consent, the MUTC allows a trust to be terminated or modified without court approval through a nonjudicial modification agreement under Mo. Rev. Stat. § 456.4A-411 (to be distinguished from a nonjudicial settlement agreement under Mo. Rev. Stat. § 456.1-111) even if the terms of the nonjudicial modification agreement are inconsistent with a material purpose of the trust.²¹ Because the terms of a nonjudicial modification agreement do not have to be consistent with the material purposes of the trust, there

are no limits under the MUTC on the types of modifications that are allowed to be made to a trust, including a full restatement or termination of the trust. If the agreement is to terminate the trust, the beneficiaries, and not the settlor, must agree on the division and distribution of the trust assets upon termination.²²

In order to be valid, a nonjudicial modification agreement must be consented to and signed by the settlor and all the beneficiaries of the trust.²³ Generally, the consent of the trustee is not required; however, if the terms of nonjudicial modification agreement change how the trust is administered, it is a good practice to have the trustee at least acknowledge the agreement since the actions of the trustee will be subject to the new administrative terms of the trust. It is critical to obtain the consents, directly or by virtual representation, of all current and future beneficiaries (not just the qualified beneficiaries) so that all parties are bound by the terms of the nonjudicial modification agreement and cannot later challenge the agreement.

The virtual representation rules for obtaining the consent of the beneficiaries under the MUTC for a nonjudicial settlement agreement are similar to the rules for obtaining consent for a nonjudicial modification agreement with two key differences. The primary differences for a nonjudicial modification agreement are for representation of an incapacitated settlor and the inability of a qualified beneficiary, in his or her capacity as a qualified beneficiary, to represent a beneficiary who is not a qualified beneficiary.

The settlor will generally consent on his own behalf; however, if the settlor is incapacitated, the settlor's consent may be obtained from (1) an agent under a power of attorney if the power of attorney expressly authorizes such an action by the agent; (2) the settlor's conservator with the approval of the court supervising such conservatorship; or (3) the settlor's conservator ad litem with the approval of the court.²⁴

When the parties enter into a nonjudicial modification agreement, a beneficiary who is not a qualified beneficiary may not be represented by a

qualified beneficiary, in their capacity as a qualified beneficiary, even if there is no conflict of interest.²⁵ This is an important difference between the representation requirements for a nonjudicial modification agreement versus a nonjudicial settlement agreement. Any adult beneficiaries (or other beneficiaries such as charitable organizations) who are not otherwise qualified beneficiaries will be required to either sign the nonjudicial modification agreement, or be virtually represented by someone who is not acting in his or her capacity as a qualified beneficiary, to make the agreement valid and binding.

If not all the beneficiaries consent, the modification or termination of the trust can still be approved by the court²⁶ if the court finds that (1) if all the beneficiaries had consented, the trust could have been modified or terminated through a nonjudicial modification agreement, and (2) the interests of the nonconsenting beneficiaries are adequately protected.²⁷ Such an approval would bind all the parties, including the nonconsenting beneficiaries under the nonjudicial modification agreement.

Decanting

Another fairly new technique that might be available to privately settle disputes is the use of the decanting statute. Decanting is the process of the trustee of one trust distributing some or all of the assets of such trust to a new second trust for the benefit of one or more beneficiaries of the original trust. Decanting was developed under common law and has been codified by the MUTC.²⁸

Decanting is an option only if the trust instrument does not prohibit its use and the trustee has a discretionary power to make distributions of income or principal to or for the benefit of one or more beneficiaries of the original trust.²⁹ In addition, a beneficiary of the second trust must have been a beneficiary of the original trust.³⁰ Decanting does not appear to allow for the addition of beneficiaries who were not beneficiaries of the original trust;³¹ however, subject to certain restrictions, beneficiaries of the original trust could be removed.³²

If the trustee of the original trust plans to decant all or a portion of the original trust, the trustee must provide notice to the permissible distributees³³ of the second trust of the plan to decant at least 60 days before actually doing so.³⁴

In order to validly decant assets from the original trust, the trustee must ensure that the decanting complies with various provisions and restrictions found in the MUTC. If the decanting process fails to comply with any of the restrictions,³⁵ the trustee will not be able to decant and any attempt to do so would be void.

When involving (1) a trust for which a marital deduction has been taken, (2) a charitable remainder trust, (3) a grantor retained annuity trust, or (4) a trust qualified as a

subchapter S trust, decanting cannot result in the reduction of any income interest of an income beneficiary.³⁶ The second trust must have the same income distribution provisions as the original trust.

Trust property that is subject to a presently exercisable withdrawal power held by a beneficiary of the original trust to whom the trustee may make distributions may not be decanted unless the beneficiary has the same power to withdrawal those assets under the terms of the second trust.³⁷

Decanting transactions require the participation of the fiduciary and involve transfer tax complexities (discussed below) and risks that likely make using this technique to settle disputes difficult without also including with the decanting

25. Mo. Rev. Stat. § 456.4-304(2).

26. As of the date of this writing, there is proposed legislation, Missouri Senate Bill 577, that would modify Mo. Rev. Stat. § 456.4B-411 to expand the court's ability to modify or terminate trusts which became irrevocable prior to January 1, 2005. Currently, the standards for court-approved modifications or terminations of trusts that become irrevocable prior to January 1, 2005 are found under Mo. Rev. Stat. § 456.590.

27. Mo. Rev. Stat. § 456.4A-411(3).

28. Mo. Rev. Stat. § 456.4-419(6).

29. Mo. Rev. Stat. § 456.4-419(1).

30. Mo. Rev. Stat. § 456.4-419(2)(1).

31. Missouri's decanting statute is silent regarding whether the new trust could give an existing beneficiary a power of appointment that could be exercised in favor of a non-beneficiary of the original trust.

32. Mo. Rev. Stat. § 456.4-419(2)(1) allows the trustees to decant the trust assets to a trust that only benefits one of the beneficiaries of the original trust to whom the trustee could make discretionary distributions.

33. The term "permissible distributee" is defined in Footnote 8.

34. Mo. Rev. Stat. § 456.4-419(3); the distributees may waive the right to the notice and eliminate the 60-day notice requirement, which would allow for the decanting to occur prior to the termination of such notice period.

35. Mo. Rev. Stat. § 456.4-419(2)(2) provides that if the trustee of the original trust is also a beneficiary of the original trust or if any beneficiary of the original trust may remove and replace the trustee with a related or subordinate party to such beneficiary (as defined in IRC § 672(c)), then unless the discretionary power to make distributions is limited by an ascertainable standard, the trustee will not have the authority to decant. In such a situation, if there is a co-trustee who is not also a beneficiary of the original trust, such co-trustee would be required to exercise the discretionary power of distribution to complete the decanting process without the participation of the trustee who is a beneficiary. Further, Mo. Rev. Stat. § 456.4-419(2)(3) provides that unless limited by an ascertainable standard, decanting cannot be done if the second trust allows for increased distributions to the trustee of the original trust or to a beneficiary that has the power to remove and replace the trustee of the original trust with a related or subordinated party or if the second trust removes restrictions on discretionary distributions imposed by the terms of the original trust.

36. Mo. Rev. Stat. § 456.4-419(2)(5).

37. Mo. Rev. Stat. § 456.4-419(2)(6).

transaction a nonjudicial settlement agreement that will release and indemnify the fiduciary.

Trust Protector

The trust involved in conflict may provide for the appointment of a trust protector. Depending on the powers granted to the trust protector, the trust protector may have the authority to modify the terms of the trust to privately settle any disputes. The MUTC lists certain powers that a trust protector may be granted under a trust, including the powers to modify, amend or terminate the trust,³⁸ subject to certain limitations.³⁹

Tax Considerations

In settling disputes, whether through a nonjudicial settlement agreement, a nonjudicial modification agreement, decanting or some other manner, counsel for the parties should analyze whether such an agreement would result in adverse tax consequences for the settlor or one or more of the beneficiaries. Depending on the terms of the agreement and the changes in beneficial interests among the beneficiaries, there could be immediate or future consequences for gift taxes, estate taxes, generation-skipping transfer taxes, or income taxes. Due to the brevity of this article, it would be impossible to cover every possible tax

issue that may arise when settling disputes, so the following is a somewhat brief sampling of tax issues that practitioners should take into consideration when considering the use of settlement agreements, modification agreements or decanting.

1. Gift Tax

Federal gift taxes are generally imposed on any transfer of property by gift by an individual regardless of whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real, personal, tangible or intangible.⁴⁰ When property is transferred for less than adequate and full consideration, then the amount by which the value of the property exceeds the value of the consideration is deemed to be a gift and may be subject to gift taxes.⁴¹

Whether entering into a settlement agreement or decanting transaction creates gift tax liability is dependent upon whether there was adequate consideration for the settlement agreement or decanting. A transfer of property in compromise and settlement of threatened litigation can be considered to be a transfer for full and adequate consideration, and thus not subject to gift tax.⁴² Alternatively, to the extent a compromise shifts beneficial interest from one beneficiary to another for less than full and adequate

consideration, such shifting of beneficial interest is deemed to be a gift from the beneficiary shifting their beneficial interest to another beneficiary.⁴³

Generally, a settlement agreement is considered to have been made for full and adequate consideration if it is the result of settling a bona fide dispute among the parties under state law, and, to the extent possible, produces an economically fair result.⁴⁴ If the agreement is legitimate under state law,⁴⁵ is the product of bona fide arm's length negotiations and is within the range of reasonable outcomes under the trust and applicable state laws, then the settlement agreement may not result in any gift tax liability.⁴⁶ However, if the settlement agreement is inconsistent with a reasonably expected outcome based upon state law, then the settlement agreement may be deemed to shift beneficial interests from one beneficiary to another, thereby creating gift tax liability for the beneficiary who is deemed to have shifted his or her beneficial interests.

2. Generation-Skipping Transfer Tax

Generation-skipping transfer ("GST") taxes are generally imposed on transfers of property by gift or at death to an individual who is two or more generations below that of the individual making the transfer.⁴⁷ Certain trusts are exempt from GST tax either because they (1) became irrevocable on or before September 25, 1985 (a "grandfathered trust")⁴⁸ or (2) have had GST exemption allocated to them by the settlor. The IRS Treasury Regulations provide safe harbors for modifying or decanting grandfathered trusts so such modification or decanting does not cause the grandfathered trust to lose its GST exempt status.⁴⁹ Agreements that might change or otherwise affect the GST-exempt status of a trust should be carefully structured to comply with the safe harbors and to avoid exposing the GST-exempt trust to GST taxation. The loss of GST-exempt status is typically never a desired result of any modification agreement or decanting transaction and should be avoided. If change to a trust shifts interest, then

38. Mo. Rev. Stat. § 456.8-808(3).

39. Mo. Rev. Stat. § 456.8-808(4).

40. I.R.C. § 2511(a).

41. I.R.C. § 2512(b).

42. *Lampert v. Commissioner*, 15 T.C.M. (CCH) 1184 (1956).

43. Rev. Rul. 77-372, 1977-2 C.B. 344.

44. *Ahmanson Foundation v. United States*, 674 F.2d 761 (9th Cir. 1981), citing *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

45. In applying federal tax law to property, the United States Supreme Court has held that state law, not federal law, generally determines the nature and extent of property interest, and the federal courts and the IRS are bound by the decisions of the highest court of the state in which the property is located. *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967).

46. Obtaining court approval of the settlement agreement may lend credence to the dispute being bona fide and the outcome of the agreement being reasonable under state law.

47. I.R.C. § 2601.

48. Treas. Reg. § 26.2601-1(b)(1)(i).

49. Treas. Reg. § 26.2601-1(b)(4)(i).

it is likely a court will need to be involved to approve the modification. Further, depending upon the specific facts, it may be appropriate to obtain a private letter ruling prior to entering into a nonjudicial modification agreement.

3. Estate Taxes

When the settlor participates in a nonjudicial modification agreement, there should not be any inclusion of the trust assets in the settlor's gross estate for estate tax purposes.⁵⁰ To alleviate any concern that the settlor's consent would cause inclusion because the settlor has retained the power to modify an irrevocable trust in conjunction with others as described in the Internal Revenue Code,⁵¹ the MUTC provides that the settlor cannot virtually represent any of the beneficiaries of the trust in a nonjudicial modification agreement.⁵²

However, without careful consideration the execution of a nonjudicial modification agreement could cause estate tax inclusion for the settlor. Due to the broad scope of nonjudicial modification agreements, the terms of the agreement could cause the trust assets to be included in the settlor's estate. For instance, in the event that the agreement modifies and restates the original terms of the trust and includes a provision that is deemed to be a retained interest, such an agreement would cause the inclusion of the trust assets in the settlor's estate.

Similarly, the parties should be wary of mistakenly causing the trust assets to be includible in the beneficiaries' estates if that is not the intent of the agreement. The inclusion of a provision granting a beneficiary a general power of appointment would cause the trust assets to be included in the beneficiary's estate at death. Such an inadvertent inclusion may create estate tax liability for property that would have otherwise been excluded from such taxes.⁵³

4. Income Taxes

In most situations, nonjudicial modification agreements, nonjudicial settlement agreements and decanting will not alter the income tax

consequences of the taxation of trust assets. Nonetheless, there are some occasions in which the income tax consequences of such actions require further consideration as described below.

When entering into a modification agreement, consideration should be given as to whether the agreement will affect the "grantor trust" status of the trust. When a trust is classified as a "grantor trust" for income tax purposes,⁵⁴ it means that the settlor is deemed to be the owner of the trust assets for income tax purposes and is responsible for paying the income taxes of the trust. It is possible that the terms of the modification agreement could cause or eliminate "grantor trust" status of the trust. By inadvertently changing the "grantor trust" status of the trust, there will be a shift in income tax liability either from the settlor to the trust or from the trust to the settlor. Among other potential adverse tax consequences, shifting income tax liability from the settlor to the trust may significantly affect the income tax liability on the trust assets due to the differences in income tax rates between trust and individuals (the top income tax rate of 39.6% in 2016 is reached for trusts at \$12,400 of income versus \$415,050 of income for single filers or \$466,950 for married couples filing jointly). Eliminating the "grantor trust" status of a trust may also cause the settlor to realize capital gains on assets the settlor sold to the trust under certain situations.⁵⁵ By shifting income tax liability from the trust to the settlor, the settlor would become responsible for a larger tax bill as a result of being responsible for paying the trust's income tax in addition to their own individual income tax, thus pushing the settlor into a higher tax bracket.

Another factor to consider in avoiding inadvertent income tax consequences is whether the trust is a shareholder in a subchapter S corporation, either as a qualified subchapter S trust ("QSST") or an electing small business trust ("ESBT"). Extra attention should be given in such circumstances to ensure that the modification or settlement agreement complies with the subchapter S corporation requirements and does not cause the trust to jeopardize its election as a QSST or an ESBT.

Conclusion

Many options exist for privately settling fiduciary disputes, which can result in saving time and money if a court is not involved. Despite appearing to be relatively straightforward, each option requires careful consideration to ensure that the agreement reached is valid and binding and does not cause unintended tax consequences to the settlor or the beneficiaries. As more options to privately change trusts become available, a greater level of scrutiny and attention to detail is needed by attorneys practicing in this area.

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50. I.R.S. P.L.R. 201233008 (Aug. 17, 2002).

51. I.R.C. §§ 2036, 2038.

52. Mo. Rev. Stat. § 456.3-301(4)

53. There are times, however, when inclusion of the trust assets in the beneficiary's estate is a goal of the modification agreement for tax planning purposes.

54. I.R.C. §§ 671 – 679.

55. Treas. Reg. §1.1001-2(a)(1).