Nonjudicial Settlement Agreements

Your Irrevocable Trust Is Not Set in Stone

By Linda Kotis

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Suppose your client, Ben, created an irrevocable trust for his sons, Adam, Hoss, and Little Joe. Ben died last year, and the trust now owns an interest in Ben's cattle ranch in Nevada. The current trustee, Sheriff Roy, has been satisfactorily handling the marketable securities owned by the trust but is concerned about his ability to manage the interest in the ranch. The beneficiaries and Roy would like to add Candy as a new co-trustee with specific powers to manage this one asset because of Candy's extensive experience as the former ranch foreman. The trust is silent on the appointment of co-trustees or a special trustee to manage an active business.

The beneficiaries and the trustee all reside in Bethesda, and the trust is governed by Maryland law. Before October 1, 2016, the interested parties would have had to petition the Circuit Court of Montgomery County to add a co-trustee and additional trustee powers. But now, with Maryland's enactment of a new nonjudicial settlement agreement (NJSA) statute, there is another solution. All the parties are thrilled to learn that they can use the NJSA to appoint Candy as co-trustee and grant special powers to manage the ranch, keep their affairs out of the public eye, and avoid the delay and expense of court proceedings.

An NJSA is a valuable tool for modifying trusts and addressing the construction of provisions when a trust is silent or unclear. It also can be used to resolve beneficiary and trustee disputes. Through an overview of the new Maryland law and a discussion of the ways in which NJSAs have been used and interpreted in other jurisdictions, this article will give the practitioner an understanding of the advantages and challenges presented by such agreements.

Overview of NJSAs

Summary

Maryland joins the ranks of 37 other jurisdictions, including Delaware, Florida, Massachusetts, and New Hampshire, by authorizing nonjudicial settlement agreements. Md. Code, Est. & Trusts § 14.5-111(d) authorizes an NJSA to cover matters including (1) interpretation or construction of a trust, (2) approval of a trustee's report or accounting, (3) direction to a trustee to refrain from a particular act or granting a trustee a specific power, (4) trustee resignations, appointments, and compensation, (5) transfer of place of administration of a trust, and (6) liability of a trustee for an action relating to a trust.

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The Maryland statute is based on Uniform Trust Code § 111(d). The Comment to UTC § 111 states that subsection (d) is a nonexclusive list and, therefore, a nonjudicial settlement agreement can be used for matters beyond those stated in the statute. Note that five states, Delaware, Idaho, Illinois, Minnesota, and Washington, which have not enacted the UTC, also have NJSA statutes. See Richard W. Nenno, *State Income Taxation of Trusts*, 869 Tax. Mgmt.: Estates, Gifts, and Trusts (BNA) VI.G.2 (2013).

Parties can enter into an agreement as long as it does not violate a material purpose of the trust and the terms and conditions would otherwise be approved by a court. Those whose interests would be affected, if the NJSA were a binding settlement approved by a court, must participate. Depending on the NJSA's subject matter, this could mean current beneficiaries, contingent and remainder beneficiaries, trustees, and the settlor. Minors and unborn children, and those who are under a disability or whose identity or whereabouts are unknown, may be represented by a person with a substantially identical interest. This is the case as long as there is no conflict of interest between the representative and the individual being represented. A party can petition for court review of whether the terms were permissible and the representation adequate under law. See Md. Code, Est. & Trusts §§ 14.5-111(a), (c), (e), and 14.5-304.

Modifying or Terminating a Trust

Commentators differ on whether an NJSA statute must expressly address its use to modify or terminate a trust. Daniel F. Hayward and Miguel D. Pena state that jurisdictions that have adopted a statute based on UTC § 111, "but did not wish for nonjudicial settlement agreements to be used to modify trusts, have seen the need to explicitly state such a restriction . . . to counteract the otherwise permissive language" contained in UTC § 111. See Daniel F. Hayward & Miguel D. Pena, *Methods for Modifying Trusts Under Delaware Law,* 15 Del. L. Rev. 95, 104 (2015). This is the approach taken by the Iowa legislature in Iowa Code § 633A.6308(2).

Gail E. Mautner and Heidi L.G. Orr maintain that a UTC state must specifically allow an NJSA to be used for modification or termination and not require court approval for such action under that state's version of UTC § 411, Modification or Termination of Noncharitable Irrevocable Trust by Consent. See Gail E. Mautner & Heidi L.G. Orr, *A Brave New World: Nonjudicial Dispute Resolution Procedures Under the Uniform Trust Code and Washington's and Idaho's Trust and Estate Dispute Resolution Acts*, 35 ACTEC J. 159, 177 (Fall 2009). This is the approach taken by the state of Oregon. See Or. Rev. Stat. §§ 130.045(5)(i) and 130.200(6).

Material Purpose

Some Maryland cases have defined material purpose in the context of a partial or complete termination of a trust. An example is *In re Trust of Lane*, 592 A.2d 492 (Md. 1991), in which the decedent had created a trust to distribute $200 per month to his son, Eugene, and his daughter, Mildred. The remaining principal was to be distributed to his three grandchildren after the deaths of both Eugene and Mildred. With all the beneficiaries' consent, the trustees petitioned for a partial termination of the trust by distributing $25,000 to each grandchild. The Circuit Court of Prince George's County denied the request, reasoning that its powers were limited to continuing the trust under its current terms or terminating the trust. Reversing the circuit court, the court of appeals ruled that the purpose of the trust was to provide

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a modest monthly payment to Mildred and Eugene, and to disburse the remainder to the grandchildren. This purpose would not be circumvented by a relatively small distribution of the trust to the intended beneficiaries. Lane, 592 A.2d at 496.

The trustee in *Convention of Protestant Episcopal Church v. PNC Bank*, 802 F. Supp. 2d 664, 669–70 (D. Md. 2011), sought to prevent the sole residuary beneficiary of a charitable testamentary trust from terminating the trust. The court denied the trustee's motion, citing the Restatement (Third) of Trusts § 65 cmt. e, which provides that, when all beneficiaries of an irrevocable trust consent, a trust can be terminated, unless termination would be inconsistent with a material purpose of the trust. In this case, the trust's prohibition against alienation, in and of itself, did not constitute a material purpose. The spendthrift clause was added in a trust amendment two years after the decedent's death and, therefore, was not part of the trust originally created by the decedent.

Scott on Trusts acknowledges that it is not always easy to determine what constitutes a material purpose. Cases have involved the creation of trusts to provide for the following: (1) successive beneficiaries, (2) postponement of enjoyment when the trust is for a single beneficiary, (3) beneficiary support trusts, and (4) a beneficiary with a disability that eventually ceases. The most common example of a material purpose is a spendthrift clause. 4 Austin W. Scott & William F. Fratcher, *Scott on Trusts* §§ 337 and 337.2 (4th ed. 1989). Nebraska modified its NJSA statute in 2004 to confirm that "a spendthrift provision is presumed to constitute a material purpose of a trust." Neb. Rev. Stat. § 30-3811(c).

Limitations on NJSAs

Statutory Limitations

Some NJSA statutes place specific limitations on the use of an agreement. Under Mich. Comp. Laws § 700.7111(2), for example, an NJSA may not be used to modify or terminate a Michigan trust. How would the prohibition on amendments affect the use of the NJSA?

Suppose Tim, the only trustee of an irrevocable Michigan trust, suffers a fatal nail gun injury, and he had not named a successor before his death. The settlor, Al, died a few years earlier in a fire caused by Tim's blowtorch. The trust agreement is silent on replacing a trustee when the trustee failed to exercise the power to appoint his successor. Mich. Comp. Laws § 700.7704(3)(a) and (b) provide two ways to fill a vacancy when no successor has been named: a trustee may be either (1) appointed in accordance with the trust's terms or (2) approved by the court.

In the absence of an NJSA, Lisa and Wilson, the trust beneficiaries, would have to petition a court to have a new trustee appointed. The availability of the NJSA means that Lisa and Wilson can agree on naming a new trustee. See Mich. Comp. Laws § 700.7111(3)(d). They could not, however, use the NJSA to add a provision to the Michigan trust for trustee appointments in the event of a future vacancy. Assuming the "if it's not forbidden, it's allowed" approach applies to permissible subject matters under the Maryland NJSA statute, the beneficiaries of a Maryland trust could both agree on naming a new trustee and also amend the trust to add a provision for appointment of successor trustees.

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Creation of Safe Harbors

In 2015, the Illinois legislature amended its statute to allow NJSAs for (1) 11 "safe harbors," see 760 Ill. Comp. Stat. 5/16.1(d)(4)(A)–(K), and (2) any other matter, as long as a court can approve the agreement's terms and conditions for that matter. See 760 Ill. Comp. Stat. 5/16.1(d)(4)(M).

This means that for the 11 safe harbors, the NJSA is not restricted by standards otherwise applicable under Illinois law. See William R. Kuehn et al., *Survey of Illinois Law: Trusts and Estates*, 39 S. Ill. U. L.J. 647, 677–78 (2015). Note that some safe harbors are limited in that the action may not violate a "clear material purpose of the trust." These include (1) the "grant to a trustee of any necessary or desirable administrative power" and (2) "[q]uestions relating to property or an interest in property held by the trust." 760 Ill. Comp. Stat. 5/16.1(d)(4)(D), (E).

Application of Safe Harbors

Suppose George established a trust three years ago for the benefit of his and Weasey's minor granddaughter, Jessica, and her future siblings. The trust is silent on providing notices and accountings to beneficiaries. According to Illinois law, a trustee is under a duty to provide complete and accurate information about the administration of a trust on a beneficiary's reasonable request. See *Continental Illinois National Bank and Trust Company of Chicago v. Phelps*, 392 F. Supp. 313, 317 (N.D. Ill. 1975). An annual accounting to beneficiaries is also required. See 760 Ill. Comp. Stat. 5/11(a).

George is worried about how affluence is affecting his family. He wishes to modify the trust's administrative provisions to withhold information concerning the existence, value, or assets of the trust and the terms of the trust until any grandchild reaches age 25. He also wants to allow an adult over age 25 to represent a beneficiary by requesting accountings and information from time to time. Illinois NJSA safe harbors include approval of a trustee's report or accounting and modification of terms pertaining to trust administration. See 760 Ill. Comp. Stat. 5/16.1(d)(4)(B) and (K). Therefore, George and Tom, the trustee, who is Jessica's other grandfather, could enter into an NJSA on these two issues. Because the minor and unborn beneficiaries must be represented, Jessica's father Lionel could represent Jessica and her unborn siblings for purposes of the agreement, under 760 Ill. Comp. Stat. 5/16.1(a)(5).

How would this safe harbor NJSA differ from a nonsafe harbor NJSA? The only modification permitted by the code for a minor beneficiary is to provide the annual account and other information to a representative for the beneficiary who is under a legal disability. See 760 Ill. Comp. Stat. 5/11(e). If this were not a safe harbor NJSA, then the agreement's terms and conditions would be limited to those that a court could approve, and such terms would not include dispensing with the annual duty to account for a beneficiary under age 25.

Judicial Review of NJSAs

All NJSA statutes are not created equal. Not only do trust code provisions vary from state to state, but also so do courts' willingness to take an expansive view of the permissible subject matter and the intent of the agreement.

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A Narrow Construction

In Testamentary Trust of Conti, No. 464 ST of 1982, 2014 Phila. Ct. Com. Pl. LEXIS 289 (Sept. 17, 2014), the parties entered into an NJSA to amend a testamentary trust to permit a sole trustee to resign. The court held that a trustee resignation was permissible only when the NJSA complied with statutory requirements for resignations without court approval and without authorization in the trust agreement. The trust modification did not contain the name of a successor or a method of appointing successors nor did it make the resignation effective after the successor accepted the appointment in writing, as required by 20 Pa. Cons. Stat. § 7765(c).
The agreement also modified the trust to permit income beneficiaries to remove a trustee without cause and without court approval. The court determined that the removal provision conflicted with "a vigorous standard of review" for trustee removal under 20 Pa. Cons. Stat. § 7766(b)(4). Factors for removal include cost, convenience to beneficiaries, personal relationship with beneficiaries, and efficiency of service, among others, as interpreted by *In re McKinney*, 67 A.3d 824, 833 (Pa. Super. Ct. 2013). Further, even while acknowledging that the list of matters under the NJSA statute at 20 Pa. Cons. Stat. § 7710.1(d) was "admittedly nonexclusive," the court stated that the "PEF code provision for [NJSAs] does not include removal as a matter that may be resolved" under the statute.

It is curious that the court did not mention 20 Pa. Cons. Stat. § 7710.1(d)(13), which allows an NJSA to address "any other matter concerning the administration of a trust," nor give any explanation as to why trustee removal would not be an appropriate subject matter. Note that one of the Illinois NJSA safe harbors is the "[r]emoval, appointment, or removal and appointment of a trustee, trust advisor, investment advisor, distribution advisor, trust protector or other holder, or committee of holders, of fiduciary or nonfiduciary powers . . . ." See 760 Ill. Comp. Stat. 5/16.1(d)(4)(F).

An Expansive View
Purcella v. Purcella, 258 P.3d 730, 733 (Wyo. 2011), involved a dispute over income generated by ownership of stock in Stor-A-Way, a self-storage business, and potential business expenses of the company. Burt Purcella had transferred the stock to the Purcella Family Trust, an irrevocable trust. On his death, the trust was divided into a Marital Trust for his widow and a Family Trust for his children. The parties argued over whether the business expenses of Stor-A-Way, such as depreciation, security deposit refunds, and expenses of administering the trust, should be deducted from income of the Marital Trust. The widow and children entered into a trust funding agreement, as permitted by Wyo. Stat. Ann. § 4-10-111, to fund the Marital Trust with 87.05% of the stock and the Family Trust with 12.95% of the stock. The agreement stated that "all income received from that company . . . shall be allocated [in proportion to such stock ownership]. The portion of the income which is allocated to the Marital Trust shall be distributed to [the widow] for as long as she is alive."

The children contended that the agreement's intent was to clarify the requirement that net income be distributed to the respective beneficiary of each trust. The Wyoming Supreme Court agreed:

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> [I]n the context of the original trust, we conclude the agreement was intended to allow disbursements of net income from the Marital Trust to Wife. One of the purposes of the Trust Funding Agreement was to clarify that Wife, rather than Children, was entitled to the income the Marital Trust received from Stor-A-Way. It does not follow that the parties intended to distribute all income the Marital Trust received from Stor-A-Way to Wife, particularly when viewed in light of the language of the original trust.

The court further stated that Mr. Purcella clearly intended that distributions were to be of net income from all trust assets. Therefore, absent clear language in the NJSA expressing intent to change the distribution standard, the widow was entitled to net income. *Purcella*, 258 P.3d at 735.

Unlike the *Conti* court, this court worked hard to preserve the NJSA. The result may have differed because the NJSA in *Purcella* conflicted with the underlying trust agreement rather than with state law.

Tax Consequences of NJSAs

Depending on the purpose of the agreement, transfer taxes, income tax, or both, may be imposed as an unintended consequence of entering into an NJSA.

GST Tax

There are a number of private letter rulings in which parties have sought confirmation of the generation-skipping transfer tax (GST) consequences of an NJSA. See, e.g., PLR 201025026, in which a nonjudicial settlement agreement modified four irrevocable trusts to add a trustee power to merge trusts, and PLR 201032026, in which the NJSA divided a testamentary trust into separate continuing trusts for grandchildren and great-grandchildren.

The regulations provide that GST tax is a risk from a "nonjudicial reformation [of a GST exempt trust] that is valid under applicable state law." Taxation would occur when the modification shifts "a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in [IRC § 2651]) than the person or persons who held the beneficial interest prior to the modification, and . . . extend[s] the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust." See Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1).

Oregon's NJSA statute permits an agreement to modify "the terms of the trust, including extending or reducing the period during which the trust operates." See Or. Rev. Stat. § 130.045(5)(i).

Gift Tax

Imposition of gift tax can occur when an NJSA is used to resolve a dispute. Under Treas. Reg. § 25.2511-1(c), a gift subject to gift tax may result from "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed."

PLR 201530008 involved a settlement agreement between trustees and beneficiaries concerning income and principal distributions from a testamentary trust and construction of the phrase "by right of representation." The IRS explained that an agreement settling a dispute "is effective for gift tax pur-

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poses [when] the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result." To determine the legitimacy of each party's claim, state law must be examined. The settlement must either reflect the result that would apply under state law or otherwise be justifiable because of the uncertainty of the outcome of potential litigation.

In this case, the IRS ruled that the issues were bona fide and based on valid enforceable claims by the interested parties. The settlement agreement to terminate the trust and divide it into two subtrusts with a per stirpes distribution of trust assets among the testator's descendants was reflective of the parties' rights under applicable state law. The IRS concluded that the terms of the settlement agreement would not cause any person to make a gift to any beneficiary.

Income Tax

Using an NJSA to define a method of determining trust income may cause a gain recognition event for purposes of IRC § 1001. Treas. Reg. § 1.643(b)-1 states in pertinent part that a switch

> to a method not specifically authorized by state statute, but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries . . . and may result in taxable gifts from the trust's grantor and beneficiaries, based on the relevant facts and circumstances.

The Preamble to the final regulations states that the following actions will not be subject to gain recognition and taxation as gifts: (1) an allocation to principal of traditional income items when "applicable state law has specifically authorized such allocation in certain limited circumstances," such as to ensure impartiality when investing for total return; (2) action taken in accordance with a state statute authorizing unitrust payments in satisfaction of an income interest or powers to adjust; and (3) action supported by a decision of the state's highest court applicable to all trusts administered under the laws of that state. If the parties seek judicial review of an NJSA, however, and a state court issues an order applicable only to the trust before the court, this would not constitute action specifically authorized by applicable state law. Thus, such an NJSA would result in imposition of tax. See T.D. 9102, 69 Fed. Reg. 12–22 (Jan. 2, 2004); Christopher P. Cline, "Trustee Investments," 861 Tax. Mgmt.: Estates, Gifts, and Trusts (BNA), at A-51 (2006).

Inheritance Tax

Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania impose inheritance tax on certain transfers to some relatives and third parties. See ACTEC 2016 State Death Tax Chart (rev. Jan. 7, 2017). Pennsylvania law states that a trust termination because of an NJSA may result in the imposition of inheritance tax when a trust for the sole benefit of a spouse is terminated. See Pennsylvania Policy Statement No. 94.3, Nov. 5, 2011. This imposition may occur unless a request for a Future Interest Compromise was made at the decedent's death with filing of an inheritance tax return. See 61 Pa. Code § 94.3(b), (c). The request allows the taxpayer to seek a compromise determination on the tax payable on a future interest. See Pa. Dep't of Revenue, Instructions for REV-1647 Schedule M. This is a curious policy because Pennsylvania has no gift tax, and outright transfers to or trusts for the benefit of a surviving

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spouse are subject to a 0% inheritance tax rate. See Amy Neifeld Shkedy & Rebecca Rosenberger Smolen, *Death and Taxes: A Primer on the Pennsylvania Inheritance Tax*, The Legal Intelligencer, March 1, 2013, at 907–08.

What to Consider Now

How should estate planning attorneys counsel clients on using a nonjudicial settlement agreement? It depends on the status of the trust. An attorney drafting a new revocable trust or irrevocable trust could inquire whether the client wishes to add a clause with material purposes of the trust. The settlor could detail her intentions about how beneficiaries and trustees might use an NJSA during her lifetime (in the case of an irrevocable trust) or after her death (in the case of either type of trust). She could forbid the use of an NJSA altogether. According to the Comments to UTC § 111, "settlors may negate or modify [NJSAs] by specifying their own methods for obtaining consents." Amending an existing revocable trust would offer similar options.

For an irrevocable trust already in place, the NJSA could address what might have been overlooked in the initial drafting. This could include clarifying definitions or ambiguous language likely to cause disputes. Potential tax consequences and varying state law interpretations mean that parties interested in NJSAs should consult a qualified practitioner when considering the use of this tool. n

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