

WEALTH MANAGEMENT STRATEGIES

# Delaware Trusts

## Safeguarding Personal Wealth

2007 EDITION



Northern Trust



## EXECUTIVE SUMMARY

The State of Delaware has long been known as the nation's corporate capital, ever since it enacted one of the first general corporation statutes in 1899. With its highly regarded General Corporation Law, and its renowned Court of Chancery, Delaware has become the pre-eminent corporate jurisdiction, with more than half of the Fortune 500 companies choosing it as their corporate domicile.

Over the years, many investors and their advisors have come to find the State of Delaware is a trust-friendly jurisdiction that promotes modern laws and attractive income tax advantages. This paper highlights the most significant of those benefits for nonresidents, and their professional advisors, who may be considering whether to establish a trust in Delaware.

As one of the leading personal trust companies in the U.S., Northern Trust is committed to meeting the increasingly complex and sophisticated wealth management needs of our clients and their advisors. We hope you find this information helpful as you strive to create meaningful legacies.



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## INNOVATIVE JUDICIAL INFRASTRUCTURE

Although Delaware has been regarded as a home to substantial personal wealth as well as trusts associated with such wealth, many of its early trusts were local in origin, with their assets tied to holdings in E.I. du Pont de Nemours & Co. and General Motors Corporation. Delaware began to attract wider attention as a trust jurisdiction in 1986 when its General Assembly completed a massive overhaul of its trust laws. Although Delaware had earlier granted a deduction for trust income of trusts held for nonresident beneficiaries, the 1986 revision began the formal recognition of so-called administrative trusts or direction trusts. The repeal of the Rule Against Perpetuities in 1995, the adoption of a self-settled spendthrift trust statute in 1997 and the enactment of the nation's first total return unitrust statute in 2000 firmly established Delaware's reputation as an innovative jurisdiction for safeguarding personal wealth.

More recently, in 2003 Delaware authorized trustees to “decant” assets from an existing trust into a new trust with modified dispositive or administrative terms, and in 2004 Delaware adopted legislation allowing non-charitable purpose trusts. The following year, Delaware rejected the nearly universal common law rule that requires a trustee to notify discretionary beneficiaries of their interests in a trust. A 2005 amendment of Delaware law allows a settlor, by express direction to the trustee, to maintain the secrecy of a trust's existence for a designated period of time. (See Figure 1.)

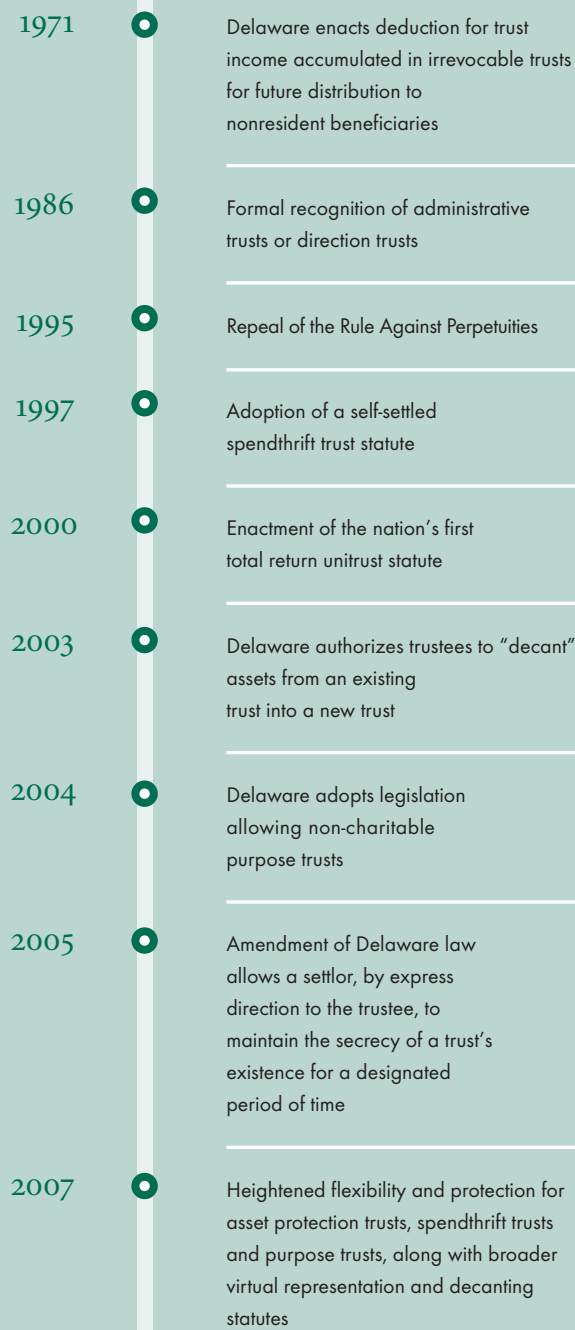
While the advances in trust law have been significant, an equally important factor is the exclusive jurisdiction of the Delaware Court of Chancery over matters of equity, which generally covers all fiduciary proceedings and disputes (and explicitly so in the case of actions under the Qualified Dispositions in Trust Act) other than the rare case involving a non-fiduciary claim for money damages against a trust or a trustee.

Figure 1

### KEY MILESTONES OF DELAWARE TRUST LAW

Many early Delaware trusts were local in origin, with their assets tied to holdings in E.I. du Pont de Nemours & Co. and General Motors Corporation.

Delaware began to attract wider attention as a trust jurisdiction in 1986 when its General Assembly completed a massive overhaul of its trust laws.



With an established body of fiduciary law and a bench comprised of highly experienced jurists, the Court of Chancery provides lawyers and their clients the assurance that if a trust dispute should ever arise, Delaware has the judicial infrastructure to resolve it efficiently and fairly.

## ADMINISTRATIVE OR DIRECTION TRUSTS

### Investment Flexibility

When the General Assembly crafted its revisions to Delaware's trust laws in 1986, the most remarkable change appeared to be the adoption of a modern portfolio approach to trust investing. Although the

By permitting trustees to take direction from authorized "investment advisors," Delaware law solves a number of common trust problems, such as concentrations and closely held business interests.

prudent investor rule has now been adopted in nearly every state, Delaware's enactment seemed almost revolutionary at the time. The new principle, codified

at 12 *Del. C.* § 3302(b), allowed trustees to depart from the traditional rule of ensuring that each and every investment was both safe and productive. *See, e.g., Lockwood v. OFB Corp.*, 305 A.2d 636 (Del. Ch. 1973) (a trustee is obliged to see that a trust is productive and that its corpus is preserved). Rather, it allowed trustees to acquire assets of virtually any nature because their investment performance would be judged on the basis of the entire portfolio. Thus, trustees could invest in a manner that had the potential to generate higher returns through investments in growth stocks, emerging markets and alternative investments as long as the portfolio as a whole was invested in a manner that a prudent investor would adopt.

In its 2007 legislative session, the Delaware General Assembly revisited the concept of investment freedom. An amendment to 12 *Del. C.* § 3303(a) allows a trust settlor to eliminate a trustee's liability for not diversifying trust assets if the language of the trust agreement directs the trustee not to diversify, or specifies the circumstances in which the assets are to remain undiversified. Prior Delaware law allowed a settlor to obviate the duty to diversify assets but left trustees under the general duty to exercise prudence in managing a concentrated position – a duty that often required a trustee to reduce such positions despite family opposition.

With the adoption of the prudent investor rule in virtually every state, the more significant change in Delaware law in 1986 was the enactment of 12 *Del. C.* § 3313(b) which, as codified, authorized trustees to take investment direction from authorized "investment advisors" named in a trust instrument, without liability for the advisors' investment results (except in the unlikely event of the trustee's willful misconduct). In the intervening years, the unique nature of § 3313(b) has led to a substantial influx of "administrative" or "direction" trusts in which some party other than the trustee (and not necessarily a registered investment adviser under the Investment Advisers Act of 1940) has exclusive responsibility for the investment of the trust assets. With the bifurcation of the trustee's traditional duties of administration and investment management, the designated investment advisor is treated as a fiduciary for the investment component (absent language in the trust agreement to the contrary).<sup>1</sup>

Apart from the obvious application of 12 *Del. C.* § 3313(b) to permit a professional investment advisor to manage a trust's assets, the administrative trust statute has provided a useful solution to a number of common trust problems.

CLIENT SITUATION:	SOLUTION:
<p><b>Concentrated position</b> A trustee of a trust with a concentrated position in a particular asset may want to sell a substantial portion of the asset to achieve greater diversification and reduce the concentration risk. The beneficiaries may oppose a sale because of their emotional attachment to the asset or simply the belief that the asset will perform well over the long term.</p>	<p><b>Value: Family committee manages concentration</b> To resolve this familiar conflict, the parties can seek to reform the trust into an administrative trust in which a family committee (composed of family members who are experienced professionals) has exclusive investment responsibility for the concentrated asset, while the trustee retains management authority over the more diversified assets.</p>
<p><b>Funding with closely held assets</b> A client wants to contribute to a family trust certain interests in a closely held operating business or investment entity, but the client is uncomfortable with the notion that the trustee would have investment responsibility for the closely held asset.</p>	<p><b>Value: Client retains control</b> If the client designates himself or herself as the investment advisor for the closely held asset, the trustee will not have any authority to interfere with the client's business or investment entity.<sup>2</sup></p>
<p><b>Non-U.S. person custodial assets in U.S.</b> A non-U.S. person who is a citizen of a politically unstable nation wants to maintain custody of his or her assets in the U.S. without subjecting the assets to U.S. income tax.</p>	<p><b>Value: Foreign trust avoids U.S. income tax</b> The grantor can create a foreign trust by causing the trust to fail the "control test" under I.R.C. § 7701(a)(30)(E) by having a non-U.S. person with authority to control all substantial decisions of the trust (i.e., investments, distributions, termination and the like). Section 3313(b) nicely accommodates the non-U.S. person's need to control the substantial decisions for the trust, leaving the trustee to furnish administrative support without liability for the actions of the non-U.S. person.</p>

The information and client scenarios presented are intended to illustrate strategies available under Delaware law. They do not necessarily represent experiences of other clients and do not guarantee a specific result. Please be advised that investment returns shown do not reflect the deduction of any fees or expenses. Results and projections may vary based upon the facts and circumstances of an individual case and may not prove valid.

### Administrative Flexibility and Protection

A 2005 amendment to § 3313(b) expanded its scope beyond investment actions so that it now applies to "distribution decisions or other decision of the fiduciary." The appointment of a distribution advisor in a trust agreement may be especially useful if the grantor wants to impose "lifestyle" standards or other subjective criteria for the beneficiaries' entitlement (or dis-entitlement) to distributions of income and principal of the trust. These sorts of standards are notoriously difficult for corporate trustees to apply because of their lack of intimate knowledge of the beneficiaries' lifestyles and the expense of gathering the pertinent information on which to base a decision. If a grantor is adamant about incorporating subjective standards

into his or her trust agreement, it may make sense to appoint a family member, a family confidante or even a professional fiduciary as a distribution advisor to make the nettlesome choices over the propriety of making or withholding distributions based on a beneficiary's "productivity" or "lifestyle."

The extent of an administrative trustee's protection from liability under § 3313(b) was the subject of the dispute in *Duemler v. Wilmington Trust Co., C.A. No. 20033 NC (Del. Ch. 2004)*, in which the co-trustee and sole investment advisor brought an action against an administrative trustee for losses the trust incurred after the investment advisor elected not to tender a bond in an exchange offer and the bond issuer subsequently defaulted on its obligation. The investment

advisor claimed that the trustee wrongly failed to deliver to him a copy of the prospectus for the exchange offer. In concluding that § 3313(b) insulated the administrative trustee from liability, the Vice Chancellor observed:

In connection with Plaintiff's decision not to tender the securities in the Exchange Offer, [the trustee] acted in accordance with Plaintiff's instructions, did not engage in willful misconduct by not forwarding the Exchange Offer materials to Plaintiff and had no duty to provide information or ascertain whether Plaintiff was fully informed of all relevant information concerning the Exchange Offer. *Id.* at 2.

Given the plain language of the trust agreement defining the respective duties of the administrative trustee and the investment advisor, it is not surprising that the Vice Chancellor ruled against the plaintiff in open court immediately following the bench trial on the plaintiff's claim. The *Duemler* decision should give substantial comfort to anyone who doubted whether a court would respect the bifurcation of a trustee's duties and exonerate a trustee for its co-fiduciary's neglectful conduct.

## SAVINGS ON FIDUCIARY INCOME TAXES

### State Income Tax Savings

The burden of state income taxes can be a significant drag on the growth in value of an irrevocable trust. In many states, realized capital gains and accumulated ordinary income of a trust are subject to income tax

The State of Delaware provides appealing opportunities for tax savings through irrevocable trusts.

rates between 5 and 10% of the income, without any distinction for the nature of the income.

Thus, in addition to the 15% rate on capital gains at the federal level, such gains may be reduced substantially more through the state tax component with rates as high as 10.5% for trusts located in New York City.

Delaware offers an appealing alternative venue for irrevocable trusts insofar as it does not impose any state income tax on the federal taxable income of irrevocable trusts that is accumulated for distribution in future years to nonresident beneficiaries.<sup>3</sup> As a practical matter, an irrevocable trust for nonresident beneficiaries will not be subject to any Delaware income tax because its income either will be distributed to its beneficiaries (with a corresponding deduction for the distribution under 30 *Del. C.* § 1635(a) and I.R.C. §§ 651 or 661) or will be accumulated (with a deduction under § 1636(a)).

As an example of the potential tax savings, if two trusts (one in California and one in Delaware) were to sell a zero-basis asset for net proceeds of \$5 million, the after-tax proceeds of the sale in the Delaware trust would be worth \$465,000 more because the proceeds in the California trust would be subject to a California income tax at a rate of 9.3%. (See Figure 2.)

Figure 2

	SALE IN DELAWARE TRUST	SALE IN CALIFORNIA TRUST
Sales Proceeds	\$5,000,000	\$5,000,000
Tax Cost	\$0	\$0
Gain on Sale	\$5,000,000	\$5,000,000
State Tax	\$0	\$465,000
Federal Tax	\$750,000	\$750,000
<b>Proceeds Net of Tax</b>	<b>\$4,250,000</b>	<b>\$3,785,000</b>
<b>Delaware Benefit =</b>	<b>\$465,000</b>	

**Assumptions:**

Federal capital gains rate: 15%

California state income tax rate: 9.3%

## Potential “Traps”

For a trust to take full advantage of Delaware’s deduction for trust income accumulated for nonresident beneficiaries, it is essential that the trust avoid a tax nexus with another jurisdiction. A number of factors can cause a Delaware trust to become subject to state income tax in another state:

- Many jurisdictions will treat a trust as a resident trust, and subject to state income tax, if it has a fiduciary residing in that state or if the trust administration occurs in that state. Thus, if a Delaware trust has an individual co-trustee located in, say, New York or California, each of those states would consider the trust to be subject to its tax regime. Similarly, if a Delaware corporate trustee delegates a major portion of its duties of trust administration to an affiliate in another state (e.g., the affiliate has full discretion to manage the trust’s investment portfolio without any supervision of the Delaware trustee), there is a risk that the affiliate’s state would consider the trust to be resident and fully taxable in that state.<sup>4</sup>
- If a Delaware trust has source income from an operating business or real estate located in another state, that state will likely claim that it is entitled to tax at least a proportionate amount, if not all, of the trust’s federal taxable income.<sup>5</sup> Portfolio managers of Delaware trusts are well-advised to avoid investments that will generate source income from a high-income tax state.
- Perhaps most significantly, a considerable number of states will attribute resident status to an irrevocable trust established in another state if the grantor of the trust was a resident of the state when the trust became irrevocable. Examples of states that have adopted this aggressive treatment of non-domiciliary trusts – known as the “residence-

by-birth” approach – include Connecticut, the District of Columbia, Illinois, Michigan, Minnesota, Ohio and Wisconsin. There may be due process grounds for challenging the constitutionality of residence-by-birth tax schemes under the Supreme Court’s decision in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) (due process clause requires minimum contacts between a state and a taxpayer to justify state’s authority to impose tax). However, following the *Quill* decision, state courts have been notably unfriendly to such claims and the Supreme Court has declined to address the issue to give fiduciaries any helpful guidance regarding their obligation to pay fiduciary income taxes to another jurisdiction.<sup>6</sup> Given the current uncertainty, residents of such states should not count on having the ability to avoid state income taxes on their irrevocable trusts located in Delaware or another trust-friendly jurisdiction.

A discussion of state taxing schemes would be incomplete without a discussion of California’s reliance on the residence of trust beneficiaries to exact an income tax from what would otherwise be a nonresident trust. Section 17742(a) of the California Revenue and Taxation Code instructs trustees that the entire income of a trust is taxable in California if the beneficiary is a California resident (unless the interest of the beneficiary in the trust is “contingent”). If there are multiple beneficiaries, some of whom are not California residents, the income taxable under § 17742(a) is apportioned according to the “number and interest of beneficiaries” resident in California. *See*, Cal. Rev. and Tax. Code § 17744. The most meaningful question that § 17742(a) poses is whether a California resident’s interest is “contingent.” The California Franchise Tax Board has not given substantial clarity to the meaning of a “contingent” beneficiary. It may be that a beneficiary’s right to receive distributions from a trust that is subject to the trustee’s discretion results in the trust

having a contingent beneficiary for California income tax purposes, particularly where there is an independent trustee. Further, the right to receive distributions conditioned on the beneficiary's survival should constitute a contingency as to that interest. Regarding the latter, the Franchise Tax Board's 2006 Form 541 Booklet states on page 6:

A noncontingent beneficiary or vested beneficiary is one whose interest is not subject to a condition precedent. A condition precedent is one which must happen before some right dependent thereon accrues, or some act dependent thereon is performed. (Survivorship is a condition precedent.)

If a grantor's intent is to establish a trust for the benefit of one or more California-resident beneficiaries, it would seem that creative drafting could render the beneficiaries' interests sufficiently contingent that the trust's accumulated income should escape the reach of the California Franchise Tax Board.<sup>7</sup>

## DYNASTY TRUSTS

### Rule Against Perpetuities

Prior to the latter part of the 20<sup>TH</sup> century every state had adopted, in one form or another, the Rule Against Perpetuities, a rule that has the effect of limiting the duration of a trust.

**Repeal of the Rule Against Perpetuities promotes wealth accumulation by permitting trusts of personal property to last potentially forever, without imposition of transfer taxes.**

Under the traditional common law Rule, all interests in the trust must vest, and the trust must terminate, within 21 years after the death of all identified individuals living at the creation of the trust. The Rule reflects a policy judgment that property owners should not be permitted to restrict the transfer of their property beyond the lives of persons who were likely known to the owner plus the minority period of the next

generation. The practical effect of the Rule Against Perpetuities was that trusts could last only a few generations, after which the remainder interests would have to be distributed outright to the class of remainder beneficiaries.

The complexity of applying the Rule, and the occasionally absurd results from the Rule's rigid enforcement (e.g., every law student's favorite, the case of the "fertile octogenarian"), caused a number of states to develop alternatives to the common law Rule, such as the 90-year period under the Uniform Statutory Rule Against Perpetuities. Whatever problems the Rule may have prompted, there were no calls for its outright abolition until the enactment of the Tax Reform Act of 1986. The 1986 Act introduced a transfer tax on generation-skipping transfers (GST). Congress intended the GST tax to apply to transfers that skipped the next immediate generation and would otherwise avoid an estate tax at that intermediate generation.<sup>8</sup> The 1986 Act provided each transferor with a lifetime exemption from the GST tax, which is currently \$2 million and will increase to \$3.5 million through 2009.<sup>9</sup> Importantly, the Code does not place any limit on the duration of a transferor's GST exemption or the duration of corresponding GST-exempt trusts. Thus, if the limit on the length of a GST-exempt trust were the applicable Rule Against Perpetuities, an extension or outright abolition of the Rule would vastly increase the number of generations who would enjoy the fruits of the transferor's GST-exempt trust, without diminution of the trust assets on account of any federal transfer tax.

### 1995 Repeal

In 1995 Delaware became the first state after the passage of the 1986 Act to repeal its Rule Against Perpetuities, thus permitting trusts of personal property to last potentially forever.<sup>10</sup> Although direct interests in real property remain subject to a perpetu-

ities period of 110 years, a Delaware trust can hold real property without limitation if the property is held through a corporation, limited partnership, limited liability company or other entity.<sup>11</sup> In the ensuing years another 16 states have adopted legislation that either repealed the Rule altogether or extended it to finite periods as long as 1,000 years.

The economic benefit of a GST-exempt (or dynasty) trust can hardly be denied. As Figure 3 shows, a client’s ability to contribute assets to a trust that will continue for generation after generation without the imposition of any transfer tax is an extraordinary opportunity when compared to the alternative of passing assets outright, from generation to generation, subject to a federal transfer tax. Assuming a \$1 million contribution to a trust, a 5% after-tax rate of return on the investment assets, a new generation every 25 years and a federal estate tax of 45% applied at each generational transfer, the GST-exempt trust would have an approximate value of \$39 million after only 75 years. The same sum of

\$1 million held outside of a trust (and subject to a gift tax or estate tax upon transmittal to each successive generation) would have an approximate value of only \$6.5 million.

With the passage of each generation, the difference in value between the GST-exempt trust and the “no-trust” alternative becomes exponentially larger. With such a compelling financial outcome, it is not surprising that Delaware fiduciaries have witnessed a dramatic influx of new trust assets in the form of dynasty trusts.

Common funding examples of Delaware dynasty trusts include the following:

- A grantor contributes cash, marketable securities or interests in a closely held entity (in the latter case, often at discounted values) to an irrevocable trust, using the grantor’s lifetime applicable gift tax exclusion (currently \$1 million, Applicable Exclusion Amount (AEA)) and allocating to the trust a portion of the grantor’s lifetime GST exemption (currently \$2 million).

Figure 3

	<b>DELAWARE DYNASTY TRUST</b>	<b>TAXABLE OUTRIGHT</b>
	TRANSFERS IN TRUST TO THE NEXT GENERATION EVERY 25 YEARS	TRANSFERS TO THE NEXT GENERATION EVERY 25 YEARS
Year 1	\$1,000,000	\$1,000,000
Year 25 Value	\$3,386,355	\$3,386,355
Transfer Tax	—	\$1,523,860
Year 50 Value	\$11,467,400	\$6,307,070
Transfer Tax	—	\$2,838,181
Year 75 Value	\$38,832,686	\$11,746,887
Transfer Tax	—	\$5,286,099
<b>Ending Value</b>	<b>\$38,832,686</b>	<b>\$6,460,788</b>
<b>Delaware Benefit =</b>	<b>\$32,371,898</b>	

**Assumptions:**

Federal estate tax rate: 45%

Return on investment assets: 5%

No state income taxes.

No distributions from trust or consumption of principal or income by persons receiving outright transfers.

- A trustee of an irrevocable life insurance trust with *Crummey* powers (with multiple *Crummey* beneficiaries) acquires a life insurance policy on the life of the grantor (or a joint and survivor policy on the lives of the grantor and the grantor's spouse), who contributes the annual premiums in reliance on his or her annual gift tax exclusions (currently \$12,000) or, in the case of a single premium insurance policy, on the AEA of each grantor. Death benefits payable to the trust often will vastly exceed the premium expense; the insurance proceeds are excludible from the grantor's estate and exempt from GST tax (assuming an allocation of the grantor's GST exemption to the trust).
- A grantor establishes an irrevocable trust that is "defective" for income tax purposes, i.e., it includes powers that will cause it to be treated as a grantor trust. The grantor contributes "seed money" to the trust, often using the grantor's AEA. The trust then acquires an asset from the grantor, typically an asset that the grantor expects will appreciate substantially, in consideration for a promissory note with interest at the appropriate Applicable Federal Rate (AFR). The grantor's sale of the asset to the trust does not cause gain recognition because, for income tax purposes, the grantor and the trust are the same entity. If the purchased assets appreciate at a rate faster than the interest rate on the note, the "hurdle" rate, the grantor will have successfully transferred the appreciation out of his or her estate.

## DELAWARE ASSET PROTECTION TRUSTS

### The Development of Delaware Asset Protection Trusts

With its passage in 1997 of the Qualified Dispositions in Trust Act, 12 *Del. C. § 3570 et seq.* ("QDTA"), Delaware became the second state to enact legislation allowing domestic asset protection trusts (the other states currently permitting such trusts are Alaska, Rhode Island, Nevada, Utah, Oklahoma, South Dakota, Missouri, Tennessee and Wyoming). In essence, the QDTA allows a grantor to create an irrevocable trust of which he or she is a beneficiary, while retaining various interests in, and

Asset protection trusts offer additional coverage against uninsured liabilities.

powers over, the trust.<sup>12</sup> Despite the grantor's continuing interest in potential distributions of income and principal from the trust, the grantor's creditors will not be able to reach the assets of the trust to satisfy their claims unless they can timely establish that the funding of the trust amounted to a fraudulent transfer.<sup>13</sup>

In recent years Delaware trustees have seen a dramatic increase in the frequency with which grantors have established asset protection trusts. The surge in popularity of these trusts has been driven, in part, by the crisis in the availability of medical malpractice insurance and, in large part by the unrelenting efforts of the plaintiffs' bar to achieve ever-larger jury verdicts and to create new theories of tort liability.

Not surprisingly, a substantial number of grantors of asset protection trusts are physicians, who are using the trusts to protect a portion of their wealth against excess, uninsured liabilities. Asset protection clients

also include corporate directors who have concerns about their personal liability for uninsured claims arising out of shareholder litigation (the insistence of the insurers in the Enron litigation that the individual directors contribute to the settlement has only fueled the demand among directors for asset protection).

Examples of asset protection trusts range well beyond the obvious candidates.

#### Situation 1

Delaware trustees are seeing trusts for elderly individuals who have lost their excess liability or “umbrella” policies due to their advanced age but want to continue driving their automobiles with reduced liability coverage.

#### Situation 2

Asset protection trusts are also serving as a substitute for prenuptial agreements, protecting the pre-marital estate of an individual without the awkwardness that accompanies the request for, and negotiations over, a prenuptial agreement.

#### Situation 3

Frequently, young adults establish asset protection trusts at the insistence of their parents, who prefer making gifts into a vehicle that is secure against future creditor and spousal claims.

#### Situation 4

More recently, Delaware trustees have observed clients using asset protection trusts to avoid state income taxes on substantial capital gains, for which avoidance of grantor trust treatment, not asset protection, is the client’s primary motive.

In short, asset protection trusts serve a variety of well-intentioned clients who simply seek to safeguard a portion of their net worth against unforeseen and uninsured claims against their wealth.

## The Prerequisites of a Delaware Asset Protection Trust

In order to qualify for the protection afforded under the QDTA, the transaction must satisfy the following basic elements:

- **Transfer to an Irrevocable Trust.** A Delaware asset protection trust begins with a transfer of assets to an irrevocable trust under the aegis of a Delaware trustee. The grantor may make a direct transfer to the trustee or may exercise a lifetime power of appointment under an existing trust. The QDTA also recognizes transfers to a Delaware trustee from a trustee of an existing trust in another jurisdiction, to the extent that the original instrument is consistent with the requirements of the QDTA.
- **Delaware Trustee.** A Delaware asset protection trust must have a Delaware-resident trustee that is either a regulated financial institution or an individual resident. In either case the Delaware trustee must “materially participate” in the administration of the trust through one or more administrative activities.
- **Reliance on Delaware Law.** A trust subject to the QDTA must expressly incorporate Delaware law to govern its validity, construction and administration unless the Delaware trust results from a trustee-to-trustee transfer from a trust existing in another jurisdiction.
- **Spendthrift Language.** A spendthrift clause that bars the attachment or assignment of a beneficiary’s interest in a trust is essential to the enforceability of the trust.

■ **The Grantor’s Interests and Powers.** The QDTA offers a broad array of interests in, and powers over, a trust that a grantor may retain:

- A grantor’s power to veto distributions from the trust;
- A limited power of appointment exercisable by will or other written instrument of the grantor effective only upon the grantor’s death;
- The grantor’s potential or actual receipt of income, including rights to such income retained in the trust instrument;
- The grantor’s potential or actual receipt of income or principal from a charitable remainder unitrust or charitable remainder annuity trust;
- The grantor’s receipt each year of a percentage (not to exceed 5) specified in the trust instrument of the initial value of the trust or its value determined from time to time;
- The grantor’s potential or actual receipt or use of principal if such potential or actual receipt or use of principal would be the result of the Delaware trustee’s acting:
  - a. In such trustee’s discretion;
  - b. Pursuant to a standard that governs the distribution of principal and does not confer upon the grantor a substantially unfettered right to the receipt or use of the principal; or
  - c. At the direction of a distribution advisor who is acting either in such advisor’s discretion or pursuant to a standard that governs the distribution of principal and does not confer upon the grantor a substantially unfettered right to the receipt or use of principal.
- The grantor’s right to remove a trustee or advisor and to appoint a new trustee or advisor;

- The grantor’s potential or actual use of real property held under a qualified personal residence trust;
- The grantor’s potential or actual receipt of income or principal to pay income taxes due on the income of the trust if the trust agreement so provides and the grantor’s receipt is subject to the trustee’s discretion or the direction of a distribution advisor; and
- The grantor’s right to have the trustee, acting either pursuant to direction or discretion, pay the grantor’s outstanding debts at the time of the grantor’s death, the expenses of administering the grantor’s estate or any estate or inheritance tax imposed on or with respect to the grantor’s estate.

### The “Tail Period” for Creditor Claims

Upon the transfer of assets to a Delaware trustee, the QDTA begins a “tail period” during which the grantor’s creditors have the right to have their claims satisfied from the assets of the trust, but *only if a creditor can prove by clear and convincing evidence that the grantor’s transfer was fraudulent within the meaning of the QDTA*. The length of the tail period will depend upon whether a particular creditor’s claim was a future claim – one that was not already in existence when the transfer occurred – or an existing claim whose inception predated the transfer. A creditor holding a future claim has a four-year tail period during which it can assert its claim of a fraudulent transfer.<sup>14</sup> For existing creditors, the tail period runs until the *later* of four years from the time of the transfer or one year from the time the creditor could reasonably have discovered the existence of the trust.<sup>15</sup> After the applicable tail

Creditors have a “tail period” during which their claims may be satisfied from trust assets – but **ONLY** if it can be proven that the grantor’s transfer was fraudulent.

period expires, the QDTA does not permit any action to enforce a claim against a Delaware asset protection trust.

The tail period incorporates a “tacking” provision that recognizes the earlier formation of a self-settled spendthrift trust that is transferred to a Delaware trustee.<sup>16</sup> Thus, a trust established under foreign law and later transferred to Delaware will have its tail period begin with the funding of the foreign trust. The practical effect of the tacking provision is to substantially shorten the tail period of a Delaware trust resulting from a trustee-to-trustee transfer.

### Exempt Classes of Creditors

The QDTA establishes two classes of “creditors” who are not subject to having their claims extinguished at the expiration of the tail period and who do not have to prove that the grantor’s transfer was fraudulent.

1. **Spouses and Children.** A spouse or child with a claim for unpaid alimony, child support or a share of marital property can satisfy its claim

Pre-marital transfers to a Delaware trust are not subject to the “spousal exemption” under § 3573(1) and can serve as a substitute for a prenuptial agreement.

out of trust assets irrespective of the time or the circumstances under which the transfer to the trust occurred.

It is significant, however, that § 3570(7) of the QDTA limits a “spouse” to a person who was married to the grantor on or before the transfer to the trust. Hence, pre-marital transfers to a Delaware trust are not subject to the “spousal exemption” under § 3573(1) and can serve as a substitute for a prenuptial agreement.

2. **Personal Injury Claimants.** A person with a claim for death, personal injury or property damage that predates a transfer to a Delaware trust may

satisfy its claim out of trust assets if the claim arose out of the grantor’s act or omission or the act or omission of someone for whom the grantor is vicariously liable.<sup>17</sup>

### The Effect of Fraudulent Transfers

Just as existing creditors and future creditors are subject to different tail periods, they also have differing tests for establishing a fraudulent transfer. A future creditor may establish a fraudulent transfer only if the grantor made the transfer with actual intent to defraud such creditor.

The standard of actual fraud applicable to a future creditor is subjective in nature and considers “badges of fraud” – factual circumstances that are suggestive of the grantor’s intent to defraud a creditor. As listed in the Delaware version of the Uniform Fraudulent Transfers Act, 6 *Del. C.* § 1304(b), the “badges of fraud” include: whether the grantor is already in litigation or is threatened with litigation, whether the grantor retained effective control over the assets, whether the grantor transferred substantially all of his or her assets to the trust and whether the grantor transferred the assets shortly before or after incurring a substantial debt. The essence of the analysis of actual fraud is whether the grantor could reasonably have anticipated the particular future creditor’s claim at the time of the funding of the trust.

An existing creditor may establish a fraudulent transfer on several grounds under 6 *Del. C.* §§ 1304 and 1305. A transfer is fraudulent as to an existing creditor if the grantor did not receive reasonably equivalent value in exchange for the transfer *and* (a) the grantor was engaged in a transaction for which his remaining assets were unreasonably small, (b) the grantor intended to incur (or believed he would incur) debts beyond his ability to repay, or (c) the grantor was insolvent at the time of the transfer or the transfer rendered the grantor insolvent. In addition to these “capital sufficiency” and “balance sheet” tests, an

existing creditor may rely on the standard of actual intent to defraud available to a future creditor.

A creditor that successfully challenges a transfer to a Delaware trust is entitled to recover its claim plus any costs and attorneys' fees allowed by the court. Importantly, the presence of a fraudulent transfer

**The presence of a fraudulent transfer with respect to one creditor will not invalidate the trust as to all creditors.**

with respect to one creditor will not invalidate the trust as to all creditors. Rather, each creditor must

demonstrate that the grantor's transfer was fraudulent in the context of that creditor's circumstances.

If the assets of a trust are not sufficient to satisfy a creditor's claim, the creditor has a limited right to proceed against trust beneficiaries to recover prior distributions. A trust beneficiary who has not acted in bad faith has the right to retain distributions resulting from the Delaware trustee's exercise of its discretion or trust powers prior to the creditor's commencement of an action to avoid the grantor's transfer to the trust. In addition, unless a creditor can demonstrate that the trustee has acted in bad faith, the creditor's claim is subject to the trustee's prior lien for the costs and expenses it incurred in defending the trust against the creditor's claim.

## The Effectiveness of Delaware Asset Protection Trusts

### Full Faith and Credit

A frequent criticism of domestic asset protection trusts is that they are susceptible to the argument that the Full Faith and Credit Clause of the U.S. Constitution compels the home jurisdiction of such trusts to recognize and enforce foreign judgments. That is, if a creditor seeks to avoid a transfer to a Delaware trust but is unable to prove a fraudulent transfer or does not assert its claim within the tail period, the

argument goes, the Delaware courts will still have to enforce the creditor's foreign judgment against the trust.

Putting aside the "undue interference" argument that Delaware need not give deference to a foreign court's judgment regarding the validity of a Delaware trust (see sidebar), there is an alternative basis for concluding that the statutory scheme under the QDTA does not violate the Full Faith and Credit Clause. As long as Delaware applies its tail periods and fraudulent transfer standards in a manner that does not discriminate against foreign judgments, it passes constitutional muster. The notion that Delaware courts would have to recognize a foreign judgment irrespective of the QDTA's avoidance standards disregards federal case law holding that statutes with procedural requirements for the enforcement of a foreign judgment do not violate the Full

### INVOKING THE FULL FAITH AND CREDIT CLAUSE

Delaware has already had one experience with a party invoking the Full Faith and Credit Clause in seeking to enforce a foreign judgment that invalidated a Delaware trust. In *Lewis v. Hanson*, 128 A.2d 819 (Del. Supr. 1957), *aff'd on other grounds sub nom. Hanson v. Denckla*, 357 U.S. 235 (1958), the beneficiaries of a Delaware trust brought an action in Florida challenging their mother's exercise of a power of appointment that arose under the trust. The Florida Supreme Court held that the plaintiffs' mother had failed to exercise her power because it did not satisfy Florida's standards for a testamentary disposition. Since the Delaware trustee had not been a party to the Florida litigation, the children sought the aid of the Delaware courts to enforce the Florida order against the Delaware trustee. In finding a valid exercise of the donee's power of appointment, the Delaware Supreme Court refused to enforce the Florida judgment, on the basis that Delaware trusts are under the exclusive supervision of Delaware courts:

*To give effect to the Florida judgment would be to permit a sister state to subject a Delaware trust and a Delaware trustee to a rule of law diametrically opposed to the Delaware law. It is our duty to apply Delaware law to controversies involving property located in Delaware, and not to relinquish that duty to courts of a state having at best only a shadowy pretense of jurisdiction.*  
128 A.2d 819, 835.

Faith and Credit Clause. That is, as long as Delaware applies its tail periods and fraudulent transfer standards in a manner that does not discriminate against foreign judgments, it passes constitutional muster.<sup>18</sup>

### ***Jurisdiction Over a Delaware Trustee***

There is always a risk, of course, that a creditor will try to avoid bringing its claim against the trust in a Delaware court, on account of its avowed hostility to enforcing foreign judgments that purport to determine the validity and enforceability of a Delaware trust. If the creditor can manage to obtain long-arm jurisdiction over a Delaware trustee and compel it to appear in a foreign court, the Delaware trustee may be faced with a court order declaring the trust to be governed by the law of the forum state, under whose law the self-settled trust is invalid, and ordering the trustee to satisfy the creditor's claim from the trust assets. No trustee would likely defy the foreign court's mandatory order to liberate trust assets, at the peril of being found in contempt of a court that asserts personal jurisdiction over the trustee.

To avoid those compulsory circumstances, §3572(g) of the QDTA strips a Delaware trustee of its authority to transfer assets to a creditor, or take any action other than to deliver the assets to a successor Delaware trustee, if a foreign court refuses to apply Delaware law to determine the validity, construction or administration of a Delaware trust. Instead, the Delaware trustee is removed from office, with the sole duty of transferring the trust assets to a successor trustee.<sup>19</sup> The selection of the successor trustee is determined under the terms of the trust agreement or, if the agreement is silent, by the Delaware Court of Chancery. In this fashion, Delaware law should preclude a creditor from obtaining relief in a foreign court that it could not otherwise obtain in a Delaware court.

### ***Protection in Bankruptcy***

In the years since the enactment of the first domestic statutes in 1997, there has been a degree of uncertainty in the trusts-and-estates bar regarding the validity of domestic asset protection trusts, especially in a state forum that does not explicitly recognize self-settled trusts. Currently, no reported decision has determined whether a domestic trust can withstand the attack of a creditor who challenges the validity of the grantor's transaction, irrespective of the creditor's ability to demonstrate actual or constructive fraud at the inception of the trust.

The 2005 amendments to the Bankruptcy Code may well lend support to the domestic asset protection trust as a planning device, notwithstanding the avowed intent of the sponsoring Senators to "close the self-settled trust loophole." Section 541(c)(2) of the Bankruptcy Code excludes from a debtor's bankruptcy estate a debtor's beneficial interest in a trust if that interest is subject to transfer restrictions enforceable under applicable nonbankruptcy law.<sup>20</sup> Under this provision a debtor's beneficial interest in a traditional spendthrift trust is protected from adjudication in bankruptcy, because the debtor does not have the authority under state law to transfer any interest in the trust.<sup>21</sup> The same provision of the Code also serves as the basis for excluding a debtor's interest in ERISA-qualified retirement plans from the bankruptcy estate.<sup>22</sup> In short, the effect of § 541(c)(2) is to put the debtor's excluded assets beyond the jurisdiction of the bankruptcy court to order a distribution in favor of the debtor's creditors.

It has long been the opinion of attorneys practicing in the asset protection field that § 541(c)(2) likely encompasses self-settled spendthrift trusts. Indeed, a debtor's reliance on a self-settled spendthrift trust is no different from the use of an ERISA-qualified retirement plan to shelter assets from the reach of

creditors while at the same time retaining a beneficial interest in such assets as well as some element of control. If the latter assets are excluded from a debtor's bankruptcy estate, there is no meaningful reason not to give similar treatment to the assets of a self-settled trust under Delaware law. And in case a bankruptcy court had any doubt about whether a debtor's interest in a QDTA trust is transfer-restricted, the QDTA is explicit in its meaning that the spendthrift provision of a self-settled Delaware trust is a restriction on a transfer of the grantor's beneficial interest in his or her self-settled trust, within the meaning of § 541(c)(2) of the Bankruptcy Code.<sup>23</sup>

The amendments in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 augment the powers of a debtor's trustee in bankruptcy to set aside prepetition fraudulent transfers. Specifically, § 548(e) authorizes the trustee to avoid any transfer to a self-settled trust or similar device made within 10 years of the filing of the bankruptcy petition if the debtor transferred the property to the trust with actual intent to hinder, delay or defraud creditors. If the exclusion under § 541(c)(2) for beneficial interests in trusts is construed in such a manner that it does not also exclude beneficial interests in self-settled trusts, it would not have been necessary for Congress to amend the Bankruptcy Code with a new § 548(e) to allow a trustee to set aside fraudulent transfers to self-settled trusts. That is, if § 541(c)(2) only applies to traditional spendthrift trusts and qualified retirement plans, a debtor's interest in a self-settled trust would be property of the bankruptcy estate and the assets of the trust would be fully available for distribution to the debtor's creditors. Thus, to avoid the conclusion that § 548(e) is superfluous, the principles of statutory construction require a finding that transfers to self-settled trusts are excluded from a debtor's estate under the plain language of § 541(c)(2), unless they are brought back into the estate under § 548(e) on account of the debtor's actual fraud within the 10-year look-back period.

With this new-found support for excluding an asset protection trust from a bankruptcy estate, a client who is facing litigation with an aggressive creditor might well consider filing a voluntary Chapter 11 bankruptcy petition. Unless the creditor could demonstrate that the client's transfer of assets to a trust amounted to actual fraud, the client's trust would be excluded from the bankruptcy estate under § 541(c)(2). Having only an unsecured claim against the client, the creditor would be compelled to accept a distribution in satisfaction of its claim equal to the amount the creditor would receive in a Chapter 7 liquidation of the client's bankruptcy estate. If the client's bankruptcy estate were either subject to secured liens or held in a tenancy by the entireties with the client's spouse, the creditor's distribution would be a fraction of the face value of the creditor's claim. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 may well have provided grantors of asset protection trusts with the means to dispose of creditor claims in an efficient and favorable manner.

**The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 may well have provided grantors of asset protection trusts with the means to dispose of creditor claims in an efficient and favorable manner.**

## **Federal Tax Consequences**

### **Federal Income Tax**

If the grantor of an asset protection trust retains the right to receive distributions of income and principal, the trust will be treated under I.R.C. § 677(a) as a grantor trust for purposes of federal income tax. As a result, the trust is disregarded and the grantor is considered the owner of all of the trust's income and deductions. However, if an adverse party (such as a member of a sprinkle class of beneficiaries) must

approve all distributions of income and principal to the grantor and the grantor's spouse, the trust will be a non-grantor trust and the grantor will not have liability for the trust's undistributed income.<sup>24</sup>

### Gift Tax

The gift tax consequences of a grantor's transfer of assets to an irrevocable asset protection trust will turn on the nature of the grantor's retained interests in, and powers over, the trust. If the grantor relinquishes control over the assets and retains no interest other than the right to receive distributions of income and principal in the sole discretion of the trustee, the grantor likely will have made a completed gift of the assets.<sup>25</sup> However, if the grantor retains other rights or powers, such as a limited power of appointment over the assets, the transfer to the trust will not be a completed gift.<sup>26</sup>

### Estate Tax

Even if a grantor effects a completed gift with a transfer to a Delaware trust, it may not follow that the trust assets will be excluded from the grantor's estate. The Internal Revenue Service has expressly declined to rule on the issue of estate inclusion, concluding that each case will require a fact-intensive inquiry to determine whether the grantor had an understanding or pre-arrangement with the trustee to permit distributions of trust income and principal to the grantor.<sup>27</sup> Evidence of such an understanding would substantiate estate inclusion under § 2036(a).

### Federal Tax Liens

A 2007 addition to Delaware's spendthrift trust statute, in 12 *Del. C.* § 3536(f), increases the potential that a purely discretionary trust established under the QDTA would not be subject to federal tax liens for the grantor's tax liabilities, at least those tax liabilities assessed after the funding of a trust. Section 3536(f)

now specifies that a beneficiary who has a purely discretionary interest in a trust, and is not eligible to receive distributions under an ascertainable standard or other enforceable standard, has a mere expectancy and not an enforceable right or a property interest in the trust. Such a discretionary interest is not subject to a creditor's foreclosure action or any legal or equitable remedy by a creditor.

A 2007 addition to Delaware's spendthrift trust law may make it difficult for the IRS to impose a tax lien on trust assets held in a purely discretionary trust.

The federal tax lien statute, 26 U.S.C. § 6321, authorizes a lien for unpaid taxes in favor of the United States against "all property and rights to property, whether real or personal, belonging to such [taxpayer]." A grantor's interest in a trust arises, if at all, under state law, and if applicable state law denies the grantor a property interest in a trust, there is nothing in the trust to which a federal tax lien can attach:

The threshold question in this case, as in all cases where the Federal Government asserts its tax lien, is whether and to what extent the taxpayer had "property" or "rights to property" to which the tax lien could attach. In answering that question, both federal and state courts must look to state law, for it has long been the rule that "in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property sought to be reached by the statute." *Aquilino v. United States*, 363 U.S. 509, 512-13 (1960).

Thus, if a client established an asset protection trust in which he or she has retained only the right to income and principal in the sole discretion of the trustee, Delaware law would disavow the existence of a property interest to which a federal tax lien would attach. The Internal Revenue Service, it would seem, would be left to its remedy under the QDTA as a general creditor, by filing a claim to set aside the transfer to the trust as a fraudulent transfer.

## Public Policy Issues

The intent of the QDTA is to strike a reasonable balance between the rights of a grantor to protect his or her assets and the rights of creditors – both existing and future – to reach the trust assets. With a substantial “tail period” for existing creditors and outright exemptions for spouses and personal injury claimants with pre-existing claims, those parties can hardly complain that the QDTA gives their debtor an unfair advantage over them in their efforts to collect on their obligations.

As for future creditors whose claims did not exist when a trust was created, they cannot seriously contend that a self-settled trust unfairly enhances the grantor’s economic advantage at their expense. That is, a commercial lender that voluntarily extends credit on the strength of assets that were neither within the debtor’s control to pledge or withdraw from the trust nor includible on the debtor’s balance sheet cannot later complain that the debtor has secreted away his or her assets. Similarly, the tort claimant whose claim arose after the inception of a trust should be held to take his defendant as he finds him, without the ability to undo the defendant’s planning strategy unless there is proof positive that the defendant “saw the claim coming.”<sup>28</sup>

Indeed, although the concept of an asset protection trust may conjure up pejorative associations, an asset protection trust that does not involve a fraudulent transfer is not fundamentally different from a number

**An asset protection trust is one more arrow in the estate planner’s quiver for ensuring the security of a client’s assets.**

of other planning transactions in which the grantor retains an interest and concurrently obtains protection against claims of the grantor’s creditors. Qualified retirement plans, individual retirement accounts, cash value life insurance policies and personal homesteads in Florida

and Texas all permit the grantor to shelter assets from creditor claims while retaining a substantially greater beneficial enjoyment of the assets as well as nearly total control over their disposition. An asset protection trust is one more arrow in the estate planner’s quiver for ensuring the security of a client’s assets.

## TOTAL RETURN UNITRUSTS AND THE POWER TO ADJUST

### Fundamentals

It is the universal experience of trustees of irrevocable income trusts (i.e., trusts with provisions for the mandatory payment of the “net income” of the trust to one or more income beneficiaries) to suffer the seemingly irreconcilable investment needs of income beneficiaries and remainder beneficiaries. Income beneficiaries realize a greater cash flow when their trusts are invested to maximize income generation through a heavier allocation toward fixed-income investments. Remainder beneficiaries view with disdain an income-driven investment approach because the trust principal will actually decline in value when the rate of inflation is included in the equation.

At the other end of the spectrum, remainder beneficiaries will realize a greater advantage if the trustee seeks to enhance the terminal value of the trust that will eventually devolve upon them. While asset growth may be best achieved through equity investments, the drawback of equity securities, from the perspective of an income beneficiary, is that their yield in the form of a dividend stream may be insufficient.

### More Equitable Distribution

Trustees of income trusts have a duty of impartiality to both classes of beneficiaries and must try to satisfy their conflicting demands. This precarious balancing act often results in an investment policy that attempts to provide both a reasonable current income yield and long-term growth that at least maintains its ground

with inflation. A portfolio mix of 65% stocks, 35% bonds would not be an unusual blend for a traditional income trust. In the end, however, the trustee's well-intentioned attempt to satisfy both classes of beneficiaries may end up disappointing them with insufficient cash flow and insufficient growth.

Delaware's total return unitrust legislation (codified at 12 *Del. C.* § 3527 and § 3527A) provides an opportunity for trustees of irrevocable income trusts to meet the investment needs of income beneficiaries and remaindermen alike and, in the process, provide investment performance that exceeds the returns of a portfolio balanced between equity and fixed-income investments. Section 3527 was enacted in June 2001 and amended in June 2004. It permits trustees of Delaware trusts to convert an existing income trust into a total return unitrust – a trust that pays the income beneficiary a percentage of the total value of the trust as determined on an annual basis rather than the trust's accounting income.

The underlying premise of a total return unitrust is that the income beneficiary receives a designated

**Delaware's total return unitrust legislation provides an opportunity for trustees of irrevocable income trusts to meet the investment needs of income beneficiaries and remaindermen alike.**

percentage of the trust's total return – the sum of its dividend and interest income and its capital appreciation.

In contrast to an income trust in which the income

beneficiary does not see any return from the growth of the trust, a total return unitrust permits the income beneficiary to participate directly in the enhanced value of the trust assets. At the same time, the remainder beneficiaries should not be troubled by the income beneficiary's receipt of a unitrust amount that exceeds the trust accounting income, because the trust's equity weighting should yield total investment performance that substantially surpasses the required unitrust payout.

## Trust Conversion Policy

### Adopt a Written Policy

Upon determining that an income trust governed by Delaware law would be appropriate for conversion to a total return unitrust, the trustee must adopt a written policy for the trust that establishes:

- The trustee's intent to make future distributions as unitrust amounts rather than as net income,
- The percentage of the trust's value that the trustee will use to calculate the unitrust (which cannot be less than 3% nor more than 5%), and
- The method the trustee will adopt to determine the fair market value of the trust.<sup>29</sup>

### Send Written Notice

The trustee must send a written notice of its intention to make the unitrust conversion (along with a copy of its written policy and § 3527) to:

- The trust settlor, if living,
- All living persons who are receiving, or are eligible to receive, distributions of trust income,
- All living persons who would receive principal of the trust if it were terminated at the time of the giving of the notice and all living persons who would be eligible to receive income or principal if the income interests of the persons identified in the previous bullet were to terminate at the time of the giving of the notice, and
- All persons serving as a trust advisor or protector.<sup>30</sup>

## Conversion

If at least one income beneficiary and one remainder beneficiary are legally competent, and no person receiving notice objects to the proposed conversion within 30 days of the receipt of such notice, the trustee may thereafter administer the trust as a total return unitrust.<sup>31</sup>

## Interested Trustee

The fact that the trustee of an income trust is an interested trustee does not impair the ability of the trustee to convert an income trust into a total return unitrust. An “interested trustee” is defined to include:

- An individual trustee to whom net income or principal is currently distributed or would be distributed if the trust were terminated,
- A trustee who may be removed and replaced by an interested distributee, and
- A trustee whose legal obligation to support a beneficiary may be satisfied by distributions of income or principal of the trust.<sup>32</sup>

With one exception, an interested trustee will follow the same procedure prescribed for disinterested trustees. The interested trustee, however, must appoint a disinterested person to act as a fiduciary for the limited purpose of setting the percentage the trustee will use for calculating the unitrust amount, establishing the method the trustee will use to determine the value of the trust, and identifying which assets, if any, the trustee must exclude in determining the unitrust amount.

## Alternative Conversion

Delaware law provides an alternative to the statutory notice procedure for converting an income trust into a total return unitrust. Any trustee may petition the Court of Chancery for an appropriate order of

conversion. Trustees will likely turn to the more formal judicial procedure to obtain approval for a conversion that would not conform to the limitations under § 3527 (e.g., selecting a unitrust percentage less than or greater than the 3% to 5% range under the statute) or to eliminate the appearance of impropriety from an interested trustee’s proposal to convert a trust.

## Charitable Trusts

Section 3527 as amended permits the conversion of trusts in which income and principal are set aside for charitable purposes under the governing instrument and for which a federal estate or gift tax deduction has been taken. The notices of conversion of the trust are to be sent to the named charitable organizations or, if none is named, to the Attorney General of the State of Delaware. In the case of a charitable trust the trustee must distribute the greater of the unitrust amount or the amount required to be distributed under I.R.C. § 4942.

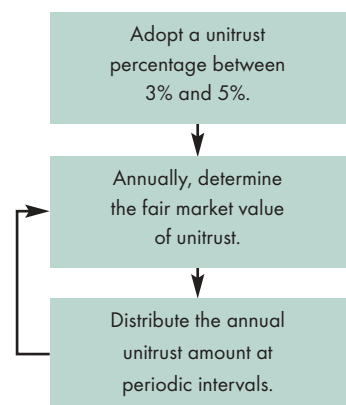
## Operational Factors for Unitrusts

Under § 3527 a trustee must closely adhere to a number of mandatory guidelines for the operation of a total return unitrust.

- A trustee of a converted income trust must adopt a unitrust percentage that is no less than 3% and no more than 5%. In

so doing, the trustee must take into account the settlor’s intentions, the needs of the beneficiaries, general economic conditions, projected current earnings and appreciation of the trust, and projected inflation and its impact on the trust.<sup>33</sup>

### UNITRUST GUIDELINES



- A trustee must determine the fair market value of a unitrust at least annually, using a valuation date or an average of valuation dates it selects.<sup>34</sup> If a trustee is unable to determine the fair market value of an asset, the trustee shall use a “reasonable and appropriate” valuation method. The value of trust property used by a beneficiary, such as a personal residence or tangible assets, may, but need not, be excluded from the value of the trust property used to calculate the unitrust payment.<sup>35</sup>
- Under the original version of § 3527(k) a trustee of a total return unitrust was required to distribute the greater of the unitrust amount or the net accounting income of the trust for two distinct types of trusts – marital deduction trusts for which a deduction has been taken under I.R.C. § 2056 or § 2523 and generation-skipping trusts that are exempt from GST tax by reason of an effective date or transition rule. In reliance on the final Treasury Regulations under I.R.C. § 643(b), the amended version of § 3527 permits QTIP trusts and grandfathered generation-skipping trusts to become pure Delaware unitrusts. In the case of a marital deduction trust, however, the surviving spouse has the right during his or her lifetime to compel the reconversion of the trust from a total return unitrust into an income trust.<sup>36</sup>

Section 3527(h), as amended, contains an ordering provision for the components of each unitrust distribution. A unitrust amount consists of the following components:

- First, net accounting income,
- Then, ordinary income not allocable to net accounting income,
- Then, (in the trustee’s discretion) net short-term capital gain and net long-term gain, and
- Finally, trust principal.

Thus, as long as a trustee adopts a consistent practice, the trustee has the option of pushing capital gains out to the income beneficiary or taking the gains in the trust. Since a unitrust will first distribute items of income that are taxed at higher rates, § 3527(h) reduces the income tax burden on the trust for its undistributed income. At the same time, the benefit of this ordering provision is that it encourages a trustee to invest the trust’s assets in a manner that will minimize ordinary income and allow more of the unitrust payment to consist of capital gains (if so allocated) and principal. The ordering provisions in § 3527 should have the effect of allowing the trustee to adopt a lower unitrust percentage to achieve an equivalent amount of after-tax income for the income beneficiary.

### Covered Trusts and Excluded Trusts

The amended version of § 3527 expands the scope of the unitrust statute from trusts that are administered in Delaware under Delaware law in its original version to include any trust, without regard to its place of administration, whose governing instrument provides that Delaware law governs matters of construction or administration.<sup>37</sup>

A trustee’s authority to convert an income trust into a unitrust under § 3527 is not available to all trusts that would otherwise fall within the scope of the statute. Section 3527(1) specifically excludes:

- Any trust whose governing instrument reflects an intention that the income beneficiaries shall receive an amount other than a “reasonable current return” from the trust,
- Any pooled income fund described in I.R.C. § 642(c)(5) or any charitable remainder trust described in I.R.C. § 664(d), and

- A trust whose governing instrument expressly prohibits the application of § 3527 by specific reference or expressly states the settlor’s intent that net income shall not be calculated as a unitrust amount (e.g., “My trustee shall not determine the distributions to the income beneficiary as a unitrust amount.”).<sup>38</sup>

### Express Total Return Unitrusts

Along with its salutary amendments to § 3527 in 2004, the Delaware General Assembly also adopted a new § 3527A to authorize the formation of express total return unitrusts. As permitted under the final Treasury Regulations governing I.R.C. § 643, § 3527A allows settlors to create new marital deduction trusts and new GST-exempt trusts that are structured from the outset as unitrusts. For example, a settlor could establish a Delaware unitrust for a spouse and obtain a gift or estate tax marital deduction for the value of the assets used to fund the trust. A “marital deduction unitrust” is available only in Delaware or another state that has adopted legislation expressly authorizing the formation of unitrusts and treating the unitrust amount as a distribution of all of the income of the trust.

The settlor of an express unitrust has a number of planning options that are not available in the case of an existing trust converted into a unitrust under § 3527. A settlor of an express unitrust may deny the trustee the discretion to change the unitrust amount or the discretion to convert the unitrust into an income trust.<sup>39</sup> In addition, instead of adopting the default ordering provision in § 3527A(h), the settlor may grant the trustee the discretion to adopt a consistent practice of treating capital gains as part of the unitrust distribution to the extent that the unitrust amount exceeds the trust’s net accounting income.

### The Power to Adjust

In 2005 Delaware adopted a new provision in its Principal and Income Act, 12 *Del. C.* § 6113, to give trustees the power to make equitable adjustments between income and principal interests. The power to adjust under § 6113

enables trustees to satisfy their duty of impartiality to all beneficiaries, without undertaking a formal conversion to a total return unitrust. The

availability of both options – total return unitrusts and equitable adjustments – confers great flexibility on Delaware trustees to treat different classes of beneficiaries fairly.

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## CONFIDENTIALITY, NON-DISCLOSURE AND FREEDOM OF DISPOSITION

### Confidentiality

Delaware law and practice traditionally have placed great emphasis on the confidentiality of matters relating to Delaware trusts, their assets, their settlors, their beneficiaries and, indeed, their existence. Delaware does not require any registration of trusts, annual meetings of beneficiaries or mandatory court docketing of trusts. In those occasional instances in which a trust is involved in a court proceeding, the Court of Chancery is generally amenable to sealing the record of the proceeding, upon the request of one of the parties, to preserve the confidentiality of the details of the trust and the family’s financial affairs.<sup>40</sup>

Unless a trust agreement expressly requires court accountings, or the trustee is compelled by court order to file an account, neither inter vivos trusts nor testamentary trusts are subject to periodic accountings.<sup>41</sup> There is no incentive, moreover, for a trustee to file a voluntary accounting to obtain approval of its prior fiduciary conduct and a release from liability. A court accounting does not have any *res judicata* effect as to matters stated in the account, unless there are exceptions to the account that are heard and determined.<sup>42</sup> If the only motive for a trustee's judicial accounting is to seek exoneration for its actions and the accounting does not result in a benefit to the trust, the Court of Chancery will impose personal responsibility on the trustee for the costs and attorneys' fees associated with the accounting.<sup>43</sup>

### Non-Disclosure

For a variety of reasons, grantors are occasionally intent on keeping the details, if not the very existence, of a discretionary trust from their offspring. Often the grantor fears that knowledge of substantial wealth will destroy his or her descendants' incentive to lead a productive life. Whatever the grantor's motivation

**Delaware trusts do not have to be filed with a court, and court accountings are not required – thereby ensuring the utmost privacy.**

to cloak a trust in secrecy, it runs counter to a trustee's common law duty to disclose to a beneficiary his or her interest in a discretionary trust.<sup>44</sup> A recent amendment to Delaware law, in 12 *Del. C.* §3303(a), permits a grantor to direct the trustee "for a period of time" not to fulfill its duty to inform the beneficiary of the beneficiary's interest in the trust. Thus, a grantor who intends to keep the beneficiaries of his or her trust in the dark regarding their beneficial interests may do so in Delaware as long as the expression of that intent is clear.

### Decanting Existing Trusts

Beginning in 1992 with New York's enactment of its EPTL § 10-6.6, a number of states have adopted legislation to allow trustees with discretion to distribute trust principal to appoint some or all of such principal in favor of another trust. This process, colloquially known as "decanting" a trust, offers trustees

**The power to "decant" a trust offers trustees the ability to modify terms of an irrevocable trust to an extent rarely possible in a judicial reformation of a trust.**

the ability to modify terms of an irrevocable trust to an extent rarely possible in a judicial reformation of a trust.

Delaware's decanting statute, 12 *Del. C.* § 3528, was first enacted in 2003. In the current form of § 3528, a trustee who has authority, under the terms of a trust instrument, to invade the principal of a trust (the "first trust") to make distributions to, or for the benefit of, one or more proper objects of the exercise of the power, may instead exercise such authority by appointing all or part of the principal subject to the power in favor of a trustee of a trust (the "receptacle trust") under a new trust instrument (or even the existing trust instrument) provided that the trustee also satisfies the following conditions:

1. The trustee must exercise the decanting authority in favor of a receptacle trust having only beneficiaries who are "proper objects" of the exercise of the power (i.e., the receptacle trust may narrow or limit the permissible beneficiaries of the first trust but it may not add beneficiaries who were not already "proper objects" of the first trust);
2. If the first trust qualifies for treatment as a minor's trust under Code § 2503(c), the beneficiary's remainder interest in the receptacle trust must vest and become distributable no later than the date upon which such interest would have matured under the first trust;

3. The trustee's exercise of decanting authority cannot reduce any income interest of any income beneficiary of a trust for which a marital deduction is taken under Code § 2056 or § 2523 or comparable state law; and
4. The trustee's exercise of such authority cannot apply to assets subject to a beneficiary's presently exercisable power of withdrawal if that beneficiary is the only person to whom, or for the benefit of whom, the trustee has authority to make distributions.

The trust agreement for the receptacle trust may include a power of appointment, even a general power, in favor of one or more of the proper objects of the first trust.

Unlike the law in some other states, the Delaware statute does not require notice to, or consent from, the beneficiaries before the decanting becomes effective. Similarly, § 3528 does not require that the trustee have absolute discretion to invade principal. Even if the exercise of discretion is subject to an ascertainable standard, the trustee may be able to decant assets to a receptacle trust.

In general terms, the process of decanting will be useful anytime an irrevocable trust agreement does not readily permit modifications under the authority of the trustee or a trust protector. Those modifications might include:

- Changing the law governing the administration of the trust to the law of a more favorable state.
- Modifying a trust's dispositive provisions (e.g., eliminating mandatory principal distributions or placing a cap on fully discretionary distributions).
- Dividing an existing trust to achieve tax benefits, such as maximizing GST-exempt assets.
- Transferring the situs of a complex trust from a high income tax state to one without an income tax on fiduciary income.
- Converting a complex trust into a grantor trust for fiduciary income tax purposes.
- Modernizing a trust's governance procedure by appointing trust advisors and protectors.

In short, the potential applications of § 3528 are almost unlimited. A trustee with sufficient discretion to invade principal can enhance the benefits of an existing trust through judicious reliance on Delaware's decanting statute.

### Purpose Trusts

At common law, a trust without definite beneficiaries, or at least readily identifiable beneficiaries, failed for lack of a proper object unless it qualified as a charitable trust.<sup>45</sup> The problem with such trusts was that without a certain class of beneficiaries, there was no one to enforce the trustee's duties under the trust agreement. In the case of a charitable trust, the power of enforcement resides in the attorney general, who has plenary authority to enforce a charitable trust within his or her jurisdiction.<sup>46</sup>

A recently-enacted Delaware statute, 12 *Del. C.* § 3555, eliminates the common law rule prohibiting non-charitable purpose trusts. Section 3555 permits a client to establish a trust for the benefit of "specific animals" living at the time of the settlor's death and, more generally, for a declared non-charitable purpose that is "not impossible of attainment."

Section 3555(d) authorizes a person appointed under the trust agreement (i.e., a trust protector) or, if there is no such person, the Court of Chancery to enforce a purpose trust. The same provision also gives standing to a person who has an interest (other than a general public interest) in the welfare of the designated animal or in the declared purpose of the trust to petition the Court of Chancery to appoint a protector or remove an existing protector.

Apart from the “lives in being” limit on a trust created to care for one or more animals in § 3555(a), there is no stated limit on the duration of a purpose trust. Since Delaware has repealed its Rule Against Perpetuities, a Delaware purpose trust can exist indefinitely. Upon the termination of a purpose trust, whether by its terms, the fulfillment of its purpose or the depletion of its assets, any remaining assets are to be distributed under the terms of the trust agreement or, in the absence of any such direction, to the settlor’s intestate heirs under Delaware law.

**EXAMPLES OF PURPOSE TRUSTS:**

- Maintaining a private cemetery on family lands.
- Maintaining and displaying a collection of fine art, antique furniture or vintage automobiles.
- Maintaining a family vacation residence.

## ABOUT THE AUTHOR

Daniel F. Lindley is president of The Northern Trust Company of Delaware. Prior to joining Northern Trust in 2005, Dan had more than 25 years of legal experience in private practice in Delaware and was the principal author of Delaware legislation repealing the Rule Against Perpetuities in 1995 and permitting self-settled asset protection trusts in 1997. A graduate of the University of Virginia School of Law and Williams College, Dan is a member of the bars of the Delaware Supreme Court and the United States Supreme Court.

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## FOOTNOTES

1. 12 Del. C. § 3313(a).
2. If it is the client's intent that such closely held assets will not be estate-includible, a practitioner who relies on this trust structure must take care to avoid the "controlled corporation" provision in § 2036(b)(1) under which a client's right to vote at least 20 percent of the combined voting power of the stock will amount to retention of enjoyment of the transferred property.
3. 30 Del. C. § 1636(a).
4. See, e.g., *Cal. Rev. and Tax. Code* § 17742(b); *Colo. Rev. Stat. Ann.* § 39-22-103(6).
5. See, e.g., *Cal. Rev. and Tax. Code* §§ 17734, 17737; *N.Y. Tax Law* § 633(a).
6. See, e.g., *Chase Manhattan Bank v. Gavin*, 733 A.2d 782 (Conn. 1999); *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997).
7. Of course, even if a trust with "contingent" beneficiaries is able to accumulate gains and income without the incidence of a California income tax, future distributions to California beneficiaries may well carry out taxable accumulated income under § 17745(b) when actually distributed.
8. I.R.C. § 2601.
9. I.R.C. § 2631(a).
10. 25 Del. C. § 503(a). Three other states – South Dakota, Idaho and Wisconsin – had repealed the Rule prior to 1986, for reasons obviously unrelated to the advent of the GST tax.
11. 12 Del. C. § 503(e).
12. The QDTA permits a grantor to choose among a litany of permissible rights including the right to income and principal in the sole discretion of the trustee, a mandatory right to income, a right to principal under a defined standard, a limited power of appointment effective at the grantor's death and the right to remove the trustee and trust advisors. 12 Del. C. § 3571.
13. Generally speaking, a creditor whose claim did not exist at the funding of the trust will have four years from the date of the grantor's transfer to the trustee to assert a claim of a fraudulent transfer; an existing creditor will have until the later of four years from the transfer or one year from the time the creditor could reasonably have discovered the existence of the trust. 12 Del. C. § 3572(b).
14. 12 Del. C. § 3572(b)(2).
15. 12 Del. C. § 3572(b)(1).
16. 12 Del. C. § 3572(c).
17. 12 Del. C. § 3573(2).
18. See, e.g., *Matanuska Valley Lines, Inc. v. Molitor*, 365 F.2d 358 (9th Cir. 1966). See also, *Watkins v. Conway*, 385 U.S. 188, 191, 87 S.Ct. 357, 358, fin. 4 (1966) (one state may not deny as untimely enforcement of a sister state's judgment if it would have enforced a local judgment of the same maturity).
19. 12 Del. C. § 3572(g).
20. A restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law is enforceable in a case under this title.
21. See, e.g., *In re Brown*, 303 F.3d 1261 (11th Cir. 2002); *In re Baker*, 114 F.3d 636 (7th Cir. 1997).
22. *Patterson v. Shumate*, 504 U.S. 753 (1992).
23. "[S]uch [spendthrift] provision of the trust instrument shall be deemed to be a restriction on the transfer of the transferor's beneficial interest in the trust that is enforceable under applicable nonbankruptcy law within the meaning of § 541(c)(2) of the Bankruptcy Code (11 U.S.C. § 541(c)(2)) or any successor provision thereto."
24. See, PLR 200637025; 200612002; 200502014; 200224701; 200148028.
25. See, PLR 9837007.

## FOOTNOTES

26. See, PLR 200148028.
27. See, PLR 9837007.
28. Cf. *Oberst v. Oberst*, 91 B.R. 97 (D.C. Cal. 1988) (transfers prompted by a plan to place property beyond the reach of potential future creditors, as opposed to transfers intended to defraud known or probable creditors, are entitled to protection under fraudulent transfer statutes).
29. 12 Del. C. § 3527(b)a.
30. 12 Del. C. § 3527(b)b.
31. 12 Del. C. § 3527(b)c and d. A trustee may use the same notice procedure to convert a total return unitrust back into an income trust, to change the percentage it uses to calculate the unitrust amount and to change the method it uses to value the trust. 12 Del. C. § 3527(b).
32. 12 Del. C. § 3527(a)(4).
33. 12 Del. C. § 3527(f).
34. 12 Del. C. § 3527(e). A trustee's adoption of an average of valuation dates may help smooth out variations in the annual unitrust amount resulting from fluctuations in a trust's market value.
35. *Id.*
36. 12 Del. C. § 3527(k).
37. 12 Del. C. § 3527(l).
38. *Id.*
39. 12 Del. C. § 3527A(d).
40. Del. Chancery Ct. Rule 5(g).
41. 12 Del. C. § 3522.
42. Del. Chancery Ct. Rule 129.
43. *Bankers Trust Co. v. Duffy*, 295 A.2d 725 (Del. Supr. 1972).
44. *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001), *aff'd in part sub nom. McNeil v. McNeil*, 798 A.2d 503 (Del. 2002).
45. *Morice v. Bishop of Durham*, 9 Ves Jr. 399 (1804).
46. See, e.g., NY EPTL § 8-1.4.

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