DELAWARE TRUSTS: HOW THEY MIGHT HELP YOUR CLIENTS IN VARIOUS STATES

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Part One

As planners and clients become more sophisticated, planners must consider how Delaware trusts would impact their clients in various states. Knowing the benefits of Delaware trusts is a solid beginning, but knowing how they could impact your clients in various states is an important step before deciding whether or not the Delaware provisions will be advantageous for your client. The states covered in this article are California, Florida, Illinois, Massachusetts, Michigan, New York (also including Connecticut and New Jersey), and Washington, D.C. (also including Maryland and Virginia). These were selected as we find that much of the Delaware trusts being established by settlors outside of Delaware are for clients in those states.

Part One discusses the following advantages of Delaware trust law: favorable tax treatment; the ability to have perpetual trusts; trust instrument flexibility; and directed trusts. Next month, Part Two will discuss other advantages of Delaware law including: decanting; self-settled asset protection trusts; moving an existing trust to Delaware from another state; Delaware's sophisticated legal and judicial environment; and Delaware's significant history and robust trust industry.

THE FIRST TWO ADVANTAGES: FAVORABLE TAX TREATMENT AND PERPETUAL TRUSTS

Favorable Tax Treatment

In general, Delaware treats a trust as a resident trust if there is at least one Delaware trustee. *30 Del. C. §1601(8)*. Delaware resident trusts may take an income tax deduction for both the amount of their federal distributable net income that is actually distributed, and for the amount of their federal taxable income that is set aside for future distribution to nonresident beneficiaries. *30 Del. C. §§1635 and 1636*. Thus, the effect is that to the extent there are no Delaware beneficiaries, there will be no Delaware fiduciary income tax on accumulated income or capital gains recognized in the trust. If there are both Delaware and non-Delaware beneficiaries, the amount of Delaware fiduciary income taxation will be reduced proportionately. This can provide a savings on the payment of taxes, if the state of the non-Delaware client does not subject a Delaware trust to that state's fiduciary income tax. If there are large capital gains on the sale of low basis assets in the Delaware trust, the savings can be substantial.

So it is important to know whether the state where the client is located will subject a Delaware trust to that state's fiduciary income tax. The following are common rationales for states to impose taxation on an out of state trust. Some states will tax an out of state trust if it was created by the will of a testator resident in the state at the time of death, or if it was created inter vivos by a settlor who lived in the state when the trust became irrevocable. Some states will impose a tax if one or more of the trustees reside or do business in the state, or if the trust is administered in the state. Some states look to the location of the beneficiaries, and will tax an out of state trust if one or more beneficiaries live in the state. Generally all states impose a tax on "source income" or income that derives directly from an asset located in that state. Source income can be an unanticipated issue if there are hedge funds or other alternative investments that have income derived directly from an asset in that state. For example, one may have a "fund of funds" investment that has multiple Schedules K-1, and in any given year may have source income in any one of the underlying investments.

The Ability to Have Perpetual Trusts

In 1995, Delaware abolished its rule against perpetuities for intangible assets. *25 Del. C. § 503(a)*. There continues to be a 110 year limit on real property held in trust. *25 Del. C. § 503(b)*. The latter rule is easily avoided, however, for entities such as corporations, limited liability corporations and limited liability partnerships owning real property may be held in a Delaware trust in perpetuity. *25 Del. C. § 503(e)*. Thus, in practice it is possible to hold any property in perpetuity in a Delaware trust.

For many years, this has been one of the more popular benefits of Delaware trusts. Although clients sometimes lose interest in the concept of having a trust that can last forever, they generally do like the idea of creating a trust that is a family savings vehicle for as many generations as needed, even up to forever. Because there can be provisions to end the trust, e.g., a power given to a trust protector to terminate the trust, clients appreciate the ability to establish what are often referred to as "dynasty" trusts. With the increase in the exemptions for gift tax and generation skipping transfer tax to $5 million per person, or $10 million per married couple, these trusts are beginning to be used even more than in the past. Clients are taking advantage of these increased exemptions while they last, to pass more wealth down as many generations as they want, including in perpetuity. Of course, if the settlor can establish a perpetual trust in his or her own state, the fact that Delaware has no rule against perpetuities is not an advantage on a stand-alone basis.

It is an even more attractive proposition to combine a perpetual trust with one that will not pay a state level fiduciary income tax. So depending on the state of the settlor, these two advantages combined can be rather persuasive.

Putting the two benefits together – a comparison for clients in various states

California – Delaware rule against perpetuities is a benefit; Delaware fiduciary income tax treatment can be a benefit. California has a rule against perpetuities. *California Probate Code §§ 21205 – 21209.* Thus, the Delaware law permitting perpetual trusts can provide an advantage for California clients.

Regarding state fiduciary income tax, California will subject a Delaware trust to California fiduciary income taxation where any of the following are present: (1) at least one fiduciary is a California resident; (2) at least one non-contingent beneficiary is a California resident; or (3) the trust has California source income. *Cal Rev & Tax Code § 17742 (2010)*. If there is a mix of Californian and non-California beneficiaries, or a mix of California and non-California fiduciaries, the tax is apportioned accordingly. Care should be given to administration occurring in California, even where there is not a California fiduciary. The California Franchise Tax Board often looks to a facts and circumstance test under which performance of various activities done in the state can lead to California taxation. Specific examples include investment decisions, client administration, discretionary distribution decisions, and other actions occurring in California by the California branch of a non-California fiduciary. Thus, if there are no California fiduciaries or beneficiaries the Delaware income tax treatment is a benefit. If there is a mixture of California and non-California trustees and beneficiaries, the Delaware advantage still exists but to a prorated extent.

Connecticut – Delaware law permitting perpetual trusts is a benefit; Delaware fiduciary income tax treatment is not a benefit**.** Connecticut has a rule against perpetuities. *C.G.S.A. § 45a-491*. Thus, the Delaware law permitting perpetual trusts can provide an advantage for Connecticut clients.

Connecticut will consider any trust established by a Connecticut resident to be a resident trust, and therefore subject to Connecticut fiduciary income taxation. *C.G.S.A. §12-701(a)(4) et seq*. See also the *Gavin* case where the court held that the non-Connecticut trust was subject to Connecticut fiduciary income taxation even where the only connection to the state was the fact that it was established by a Connecticut settlor. *Chase Manhattan Bank, Trustee, et al v. Gene Gavin, Commissioner of Revenue Services, SC 15875, argued October 27, 1998, released June 1, 1999*. Thus, a Connecticut resident will not be able to avoid a state level fiduciary income tax on a Delaware trust, as there will be a Connecticut fiduciary income tax. Accordingly, the Delaware income tax treatment will not be a specific benefit to a trust established by a Connecticut settlor or testator.

<u>Florida – neither Delaware law permitting perpetual trusts nor Delaware fiduciary income tax treatment is a benefit</u>. Florida modified its rule against perpetuities by extending the perpetuities period to 360 years. *Fla. Stat. § 689.225*. Thus, the Delaware law permitting perpetual trusts does not necessarily provide a specific advantage for Florida clients.

Florida does not have a state level income tax, including fiduciary income taxes. As a result, there will not be a Florida tax on a trust created in that state nor in Delaware, regardless of the location of trustees, settlor, or beneficiaries. Therefore, the Delaware income tax treatment will not be a specific benefit. Florida is a state where neither of these two advantages necessarily provides an advantage to your client.

<u>Georgia - Delaware law permitting perpetual trusts is a benefit; Delaware fiduciary income tax treatment can be a benefit</u>. Georgia has a rule against perpetuities. *O.C. G.A. 44-6-*

201 (2010). Thus, the Delaware law permitting perpetual trusts can provide an advantage for Georgia clients.

Regarding fiduciary income taxes, Georgia does not look to the location of the settlor nor fiduciary. Rather Georgia will impose a state fiduciary income tax on every trust where the trust is: (1) receiving income from business done in Georgia; (2) managing funds or property located in Georgia; or (3) managing funds or property for the benefit of a Georgia resident. *O.C.G.A. § 48-7-22.* Thus, whether the Delaware tax treatment will be a benefit will depend on whether there is trust property or beneficiaries in Georgia.

Illinois – neither Delaware law permitting perpetual trusts nor Delaware fiduciary income tax treatment is a benefit. Illinois does not have a rule against perpetuities for "qualified perpetual trusts", which is any trust created after January 1, 1998 that expressly states that the rule does not apply, and that the trustee has the unlimited power to sell assets. *765 ILCS 305 / 4*. Thus, the Delaware law permitting perpetual trusts will not necessarily be an advantage for an Illinois client.

Illinois imposes a tax on resident trusts, which is defined as a trust where the settlor was domiciled in Illinois at the time the trust become irrevocable. *35 ILCS / 201(a) and 1501(a)(20)*. Thus, similar to Connecticut, a trust established by an Illinois resident will not be able to benefit from the Delaware tax treatment on trusts. As a result, Illinois clients will not benefit from these first two Delaware advantages.

Maryland - Delaware law permitting perpetual trusts is not a benefit; Delaware fiduciary income tax treatment may be a benefit. Maryland has abolished its rule against perpetuities. *Md.*

Code Ann., Est. & Trusts § 11-102(b)(5). Thus, the Delaware law permitting perpetual trusts does not provide a specific advantage for Maryland clients.

Maryland defines a resident trust subject to taxation as: (1) a testamentary trust created under the will of a Maryland resident at death; (2) an inter vivos trust that was created by a settlor who is a *current* resident of Maryland, or (3) a trust that is principally administered in Maryland. Thus, for inter vivos trusts it is necessary to determine each year whether the settlor is a current resident of Maryland. If a settlor moves away from the state, the taxation could change, so that there would be no Maryland state fiduciary income tax. *Md. Code Ann. Tax-Gen. Art. § 10-103.* Maryland provides that a nonresident beneficiary subtraction may be claimed by a resident fiduciary to the extent the subtraction amount is included in its federal taxable income. This subtraction includes: (1) income derived from intangible personal property that is held in the trust for the benefit of a nonresident, and (2) capital gain income derived from the sale or other disposition of intangible personal property that is held in the trust, if the proceeds are added to the principal of the trust, and all of the remaindermen of the trust are nonresidents during the entire taxable year. Md. *Code Ann. Tax-Gen. Art. § 10-207(o)*. Furthermore, all resident Maryland trusts also must pay a local county income tax. *Md. Code Ann. Tax-GenTax-Gen. Art. § 10-103*. Accordingly, in a given year, if the settlor of an inter vivos trust is not a resident of Maryland and there are no Maryland beneficiaries, the trust will benefit from the Delaware tax income treatment. Unlike many states, this is an analysis that should occur each year.

<u>Massachusetts - Delaware law permitting perpetual trusts is a benefit; Delaware fiduciary income tax treatment can be a benefit</u>. Massachusetts has a rule against perpetuities. *Mass.*

Code, Title I, Chapter 184A. Thus, the Delaware law permitting perpetual trusts can provide an advantage for Massachusetts clients.

Massachusetts defines a resident inter vivos trust subject to fiduciary income tax as one where one trustee is a resident of the state, **and** one of the following is also present: (1) the settlor was a Massachusetts resident at the time the trust was created; (2) the settlor resided in Massachusetts for any part of the year; or (3) the settlor died a resident of Massachusetts. As a result, assuming there is no Massachusetts co-fiduciary, the Delaware income tax treatment can be a benefit. *ALM GL ch. 62, § 10 (2011).*

<u>Michigan – Delaware law permitting perpetual trusts is not a benefit; Delaware fiduciary income tax treatment can be a benefit</u>. Michigan modified its rule against perpetuities in 2009, making the rule against perpetuities and similar rules affecting the duration of trusts inapplicable under Michigan law with respect to personal property held in trusts that are revocable on or created after May 28, 2008. *Mich. Pub. Acts 148*. Thus, the Delaware law permitting perpetual trusts does not provide an advantage for Michigan residents.

Michigan defines an inter vivos resident trust subject to fiduciary income taxation as one created by a settlor domiciled in Michigan at the time the trust became irrevocable. *MCLS § 2206.18 (2011).* In the *Blue* case, however, the Michigan Court of Appeals ruled that the imposition of a state income tax on a trust that owned no income-producing property in the state violated the Due Process Clause of the United States Constitution. *Blue v. Michigan Department of Treasury, 185 Mich. App. 406 (1990).* Consequently, Michigan cannot impose an effective fiduciary income tax on income accumulated or capital gains realized in an inter vivos trust as long as all of the following conditions are met: (1) the trustee is not a Michigan resident;

(2) the assets of the trust are neither held, located, nor administered in Michigan; and (3) the beneficiaries are all nonresidents. So even if the settlor was initially a Michigan resident, if there are no other connections, including no beneficiaries in Michigan, then the Delaware income tax treatment can be a benefit.

<u>New Jersey – Delaware law permitting perpetual trusts is not a benefit; Delaware fiduciary income tax treatment is a benefit</u>. New Jersey abolished its rule against perpetuities effective July 1999, as part of the Trust Modernization Act of 1999. *N.J.S.A. 46: 2F-9 et seq.* Thus, the Delaware law permitting perpetual trusts does not provide an advantage for New Jersey clients. Note that New Jersey still has a rule against alienation, which can be overcome in various ways, including giving a trustee the power to substitute assets.

In the *Pennoyer* case, New Jersey ruled that Resident Trusts cannot be taxed on all their income if the only contact is the domicile of the settlor. *Pennoyer v. Taxation Div. Director*, *5 N.J. Tax 386*, *1983*. Unlike New York (*see infra*), however, there are no regulations creating a safe harbor, and the New Jersey statute has not been revised to take into account the court rulings. New Jersey defines a resident trust subject to fiduciary income taxation as a one created by a New Jersey settlor, or under the will of a New Jersey decedent. Although there is no statutory safe harbor, in practice the rule is that a New Jersey resident trust will not be subject to New Jersey fiduciary income tax as long as all of the following are true: (1) the trust holds no New Jersey located assets; (2) there are no New Jersey fiduciaries; and (3) there is no New Jersey source income. Thus, residents of New Jersey can take advantage of the Delaware tax treatment, assuming the conditions listed are satisfied.

New York – Delaware law permitting perpetual trusts and Delaware fiduciary income tax treatment are both benefits. New York has a rule against perpetuities. *EPTL § 9-1.1*. Thus, the Delaware law permitting perpetual trusts can provide an advantage for New York clients.

New York defines a resident trust subject to fiduciary income taxation as one created by a New York settlor, or under the will of a New York decedent. As provided under regulations, a New York resident trust will not be subject to New York fiduciary income tax as long as all of the following are met: (1) the trust holds no New York located assets; (2) there are no New York fiduciaries; and (3) there is no New York source income. *New York Tax Law § 605*. Thus, residents of New York can take advantage of the Delaware tax treatment, assuming the three prong test is met.

Note that New York now has a notice requirement on all resident trusts that are exempt from paying New York fiduciary income tax. Specifically, as of 2011, New York resident trusts that are exempt from the payment of New York State income tax under the three-prong test must attach a new *Form IT-205-C, New York State Resident Trust Nontaxable Certification*, to a completed fiduciary income tax return.

Virginia - Delaware law permitting perpetual trusts is not a benefit; Delaware fiduciary income tax treatment can be a benefit. Virginia has abolished its rule against perpetuities. *Va. Code Ann. § 55-13.3(c)*. Thus the Delaware law permitting perpetual trusts does not provide an advantage for Virginia clients.

Virginia defines a resident trust as a testamentary trust created under the will of a Virginia resident at death, or an inter vivos trust that was created by a Virginia resident when it became irrevocable. *Va. Code Ann. § 58.1-302*. Virginia will impose a state fiduciary income tax if there is a continued nexus with the state. According to *Virginia Public Document No. 93-183, August 26, 1993*, for a trust that was created by a Virginia domiciled decedent, at least one of the following must be present to establish sufficient nexus to impose a tax: (1) there must be a resident beneficiary; (2) there must be a resident fiduciary; or (3) there must be tangible property located in the state. Furthermore, Virginia has ruled that a trust that was created by a decedent who was domiciled in Virginia, but had no beneficiaries living inside the state, was subject to Virginia fiduciary income tax due to the fact that there was a Virginia co-trustee who held and managed a small checking account as part of the trust for administrative purposes. *Virginia Public Document Ruling No. 99-168, dated June 22, 1999*. Virginia has ruled, however, that there will not be a Virginia fiduciary income tax where there is not sufficient nexus to the state. In the specific ruling, there was a series of trusts where the only connection to Virginia was a resident co-trustee who acted in tandem with several other non-resident co-trustees. In this instance, the state ruled that the trust was not subject to Virginia fiduciary income tax because the Virginia co-trustee could not exercise control over the trust as an individual. *Virginia Public Document Ruling No. 07-164, dated October 17, 2007*. Thus, in the correct fact pattern, the Delaware income tax treatment can be an advantage.

Washington, D.C. – Delaware law permitting perpetual trusts could still be considered a benefit; Delaware fiduciary income tax treatment could be a benefit. Washington, D.C. has extended its rule against perpetuities to 150 years. *RCW § 11.98.130.* Thus, there arguably is still an advantage in Delaware regarding perpetual trusts.

Washington, D.C. defines a resident trust subject to fiduciary income tax as a testamentary trust created under the will of a D.C. resident at death, or an inter vivos trust that was created by a resident of the District when the trust became irrevocable. *D.C.Code §47-1809.3 (2011).* If there is a co-fiduciary or beneficiary in the District, there is sufficient nexus to levy a tax. If there is neither a co-fiduciary nor beneficiary in the District, look to other factors such as whether there is situs property or source income from Washington, D.C. If there are no connections other than the original Washington, D.C. settlor or testator, look to the *Guth* case in which the District of Columbia court held that, in a testamentary trust that was being subjected to tax by the District, the Due Process Clause did not prevent the District from imposing a tax, given the continuing supervisory relationship that the District's courts have with respect to administration of such a trust. In so doing, the court rejected several decisions in other states holding that due process requires a greater connection between the trust and the taxing jurisdiction than the residence of the settlor. *District of Columbia v. The Chase Manhattan Bank, No. 95-TX-1599, Argued Dec. 19, 1996 – January 30, 1997*. In Footnote 11 of the case, however, the court stated that it expressed no opinion as to the constitutionality of taxing the entire net income of inter vivos trusts based solely on the fact that the settlor was domiciled in the District when she died and the trust therefore became irrevocable. Specifically, that footnote left open the possibility of an inter vivos trust not being subject to tax where there is no continuing nexus to the District. *District of Columbia v. The Chase Manhattan Bank, infra, Footnote 11*. Thus, there is an argument for taking a filing position of no tax due on an inter vivos trust where there are no continuing connections to the District. In those cases the Delaware income tax treatment can be an advantage.

TRUST INSTRUMENT FLEXIBILITY – NOTICE TO BENEFICIARIES AS AN EXAMPLE

In Delaware, the trust instrument can expand, restrict, eliminate, or otherwise vary the rights of beneficiaries. This includes the right of a beneficiary to be informed of his or her interest in the trust, for a period of time. *12 Del. C. § 3303(a).* The instrument can also expand, restrict, or eliminate the trustee's powers, duties, standard of care and liability, and can exculpate a trustee for acts other than willful misconduct. *12 Del. C. § 3303(a).* Notice that the statute states "for a period of time" when specifying that the trust instrument can restrict, eliminate, or otherwise vary the rights of beneficiaries to be informed of their interest.

It is becoming more common for clients to request that the trust have a provision that the trustee does not have to, or in some cases cannot, provide notice of the trust to the beneficiaries. This has sometimes been referred to as a "silent trust". The wording of the statute clearly provides for that as a viable provision in a trust instrument. Delaware law is not clear, however, about what is meant by "for a period of time."

One can imagine two ends of the spectrum of requests. A client might come into your office wanting to establish a trust for his or her family, where the beneficiaries will not be informed of the trust during the client's lifetime, or even during the beneficiaries' lifetimes, unless distributions are made to them. The wording of the statute would allow for this. But a trustee may not be comfortable with this approach, and indeed, as the client's attorney, you might not be comfortable with drafting this provision into the trust. On the other end of the spectrum, a client might come into your office wanting to establish a trust where one of the beneficiaries is not informed of the trust for six months, because that beneficiary is graduating college in six months and the client does not want to do anything to reduce the beneficiary's incentive to complete his or her education. Again, this would clearly be permissible under the language of the statute. Here a trustee would likely be much more willing to serve in such a situation, as this does not seem to violate public policy, and in fact likely serves a good purpose.

It is worth noting that the Delaware statute provides the flexibility to a drafting attorney to create a trust, and to a trustee to serve in a trust, anywhere along the spectrum described above. It is also worth noting that at this time there is no reported case law on this issue.

This statute is, in fact, a response to prior case law in Delaware, in particular the *McNeil* case. In that case, the court ruled that the trustee had erred, and surcharged the trustee where the trustee had been providing statements to all but one of the trust beneficiaries. In its ruling, the court stated that the trustee has a duty of impartiality among beneficiaries, and should have a policy in place when deciding whether to provide statements. But the court did not provide direction on when it was required to provide notice and or statements. *McNeil v. McNeil, 798 A. 2d 503 (Del. 2002).* The Delaware statute, *12 Del. C. § 3303(a),* was amended after that case to provide that the governing trust instrument can provide the rules of the road.

If the trust instrument does not address notice, the trustee defaults to case law, which as noted above is not entirely clear. Again, the *McNeil* case did not provide a specific roadmap. The trustee will likely determine that it is required to provide notice to all beneficiaries after reaching an age of majority, unless there are specific reasons not to for any given beneficiary. Therefore, as a drafting matter, the attorney should carefully review with his or her client what the client's wishes are regarding the trustee providing notice to beneficiaries.

Note that none of the other states being discussed in this article permit a trustee to not provide notice to a beneficiary. Florida is the one state that has a provision different than the other states, and closer to Delaware. Specifically, Florida law permits the trust agreement to designate a representative to receive notice and statements on behalf of the beneficiaries. *Fla.*

Stat. § 736.0306. Thus, although Florida law still requires that notice be provided to a beneficiary, if the trust agreement provides that a representative can receive notice, in effect the beneficiary might not have actual knowledge of the trust. In discussing this with Florida attorneys, as well as Ohio attorneys because Ohio has a similar provision, it appears that this provision is not used as often as one might initially think. The reason is that it can be difficult to find a person who is willing to take on that responsibility. Nonetheless, the Florida provision was recently enacted in 2010, and may gain more usage over time.

An interesting contrast to the concept of not providing notice to beneficiaries is the ability in Delaware to provide notice, thus creating a specified time period that a beneficiary can question the validity of the trust. Specifically, Delaware law limits the ability to contest the validity of a trust by specifying a period of the earlier of 120 days after receiving notice of the trust, or two years after the settlor's death. *12 Del. C. § 3546*. Here, rather than avoiding potential issues raised by beneficiaries, the settlor can bring any discussions to a head by giving notice to anyone he or she thinks might raise an issue regarding the validity of the trust. Note that this includes sending notice to people who are not beneficiaries under the trust agreement.

This discussion of providing notice to beneficiaries or informing them of a trust agreement is illustrative of various flexibilities that can be obtained under Delaware law. As noted above, it is important for the attorney advising the client, and the trustee acting under the instrument, to be comfortable with the decisions made by utilizing this flexibility. Not every capability created by the flexibility is the right decision. It depends on the fact pattern and the parties involved.

DIRECTED TRUSTS

Although directed trusts are a common element in Delaware practice, this concept is not unique to Delaware. In fact, over 30 states have some form of directed trust statute, with the statutes falling into three categories. The first category is the eleven states that have enacted directed trust statutes with significant protection by providing that a directed trustee is liable only for deficient execution of direction, willful misconduct, or not at all. The second category consists of the states that have fully adopted the Uniform Trust Code, including a form of its directed trust provision. Specifically, the Uniform Trust Code provides that a trustee will not be liable for any loss arising from following the direction of a trust advisor, unless that direction is manifestly contrary to the terms of the trust or if the trustee knows the direction is a serious breach of fiduciary duty of the directing person. *Uniform Trust Code § 808(b).* Note that this puts an obligation on the trustee to review the directions before acting on them. Lastly, the third category consists of two states following the Restatement 2nd approach, which provides that the directed trustee is liable if the direction violates the terms of the trust or fiduciary duty of the directing person. *Restatement 2nd § 185*. This provides the least amount of protection for the trustee among the three categories, because under the Restatement 2nd approach the trustee must ensure that each direction is not violating the terms of the trust agreement or the fiduciary duty of the person providing the direction.

<u>Benefits of Directed Trust Statutes</u>

Before discussing the specifics of the Delaware directed trust statute and comparing it to our other states under consideration in this article, it makes sense to consider why directed trusts have become so popular. It is a fair statement to say that the demographics of the trust industry reflect settlors who want more control as a general proposition. But more specifically, there are three categories of situations that often lead to the need for directed trusts. The first category is the patriarch or matriarch who has created significant wealth through some specific asset or assets. This can be an operating company, investment in real estate, closely held entities, or many other ways that wealth is created. This is different than the industry fifteen years ago when much of the trusts in existence were for inherited wealth. Since the technology boom in the late 1990's and various other areas of wealth creation in the past fifteen years, many of the clients settling trusts are people who have created significant wealth in recent years. Often times they realize the value of wealth transfer to successive generations, as well as the various other benefits that go along with establishing a trust. Nonetheless, they absolutely expect that part of the assets held (if not all of the assets) will be an interest in the entity that created their wealth. It makes sense to think of a patriarch or matriarch wanting to place the money making entity in the trust that will benefit generations to come. But unless the trustee is directed, the trustee will have a difficult time serving the needs of the client. The client will likely become frustrated when the conversation regularly turns to diversification of the very asset that he or she wants to keep in the trust until sometime in the future. So the likely fact pattern in this first category is that the trustee will provide investment management over a portion of the assets in the trust, and be directed on specific assets. Often times it is the settlor who is the adviser directing the trustee. As long as the direction is limited to investment matters, and does not create a direction regarding distributions, the directions will not cause the assets to be brought into the estate of the settlor who is the party directing. There is a long line of case law that provides that management powers that a decedent might possess under a trust instrument do not cause inclusion of the trust property in the gross estate, as long as those powers do not amount to a power to alter the trust. *See e.g., US v. L.T. Powell, CA-10, 62-2 USTC, 307 F2d 821 (1962)*.

The second category is where the client has a very large amount of wealth to place in the trust or trusts, for example $100 million or more. Here, the client often wants to diversify among several investment providers for the trust. So the trustee will provide investment management for a portion of the assets, and be directed to hire other investment managers for the balance of the trust.

The third category is where the client just is not ready to cede investment control to anyone other than himself or herself (which may create estate tax problems under IRC § 2036(b) if the investment is a closely-held corporation). This is the one category where the trustee would not provide investment management for any of the assets.

In reality, there is often a combination of these three categories.

The Delaware Statute

Having reviewed the reasons for needing directed trust provisions to fully serve the settlors and beneficiaries, let's look at the Delaware directed trust statute. Delaware's "trust adviser" statute provides that an adviser may be appointed under the trust instrument to direct, consent, or veto any investment, distribution, administrative, or any other trustee decision. In the absence of willful misconduct on the part of the trustee, the trustee will not be responsible for any loss resulting from following the directions of the trust adviser. *12 Del.* C. *§ 3313*. Willful misconduct is defined in the statute as "intentional wrong doing, not mere negligence, gross negligence, or recklessness". *12 Del. C. §§ 3301(a) and 3301(h)(4).* Thus, the trustee must do something that it knows is not proper. A clear example is that the trustee would not be protected for following a direction to make a distribution to someone who is not a beneficiary of the trust.

The statute provides that the adviser shall be considered to be a fiduciary when exercising such authority, unless the governing instrument otherwise provides. *12 Del. C. § 3313 (a)*. Note that having a trust adviser direct the trustee can interact with the state income tax treatment of the trust, if the given state of the client would impose taxation when there is a fiduciary in that state. For example, if the trust was created by a New York settlor when it became irrevocable, it will be a New York resident trust. As discussed in the section on state level fiduciary income taxation of Delaware trusts, a New York resident trust will not be subject to New York fiduciary income tax as long as there is no New York fiduciary, among other requirements. Thus, if the trust adviser is a resident of New York and is a fiduciary, this could subject the trust to taxation by New York. Arguably, if the level of direction by the adviser was minimal, say only over a small portion of the assets, and the trust instrument stated that the adviser is not a fiduciary, an position could be taken that the trust is not subject to New York fiduciary income tax. Historically if this position were taken, the trustee might file a New York return showing no New York tax due, to start the statute of limitations running. As noted above, however, New York now has a notice requirement on all resident trusts exempt from New York fiduciary income tax.

The Delaware statute also provides the flexibility of the trustee acting at the consent of an adviser. *12 Del. C. § 3313 (c)*. This can be useful where the client wants the trustee to provide guidance, but wants the final say to be with the trust adviser. This is similar to being out voted by a co-trustee, except under this statute there is no residual liability to disagree with the ultimate decision. Note that the standard of liability under this section is willful misconduct or gross negligence on the part of the fiduciary. The lower standard of gross negligence applies to the fact that the trustee is expected to make recommendations. The standard of willful misconduct applies to the fact that, once the trustee does not receive the consent of the trust adviser, the trustee will not be liable for loss unless it acts with willful misconduct.

The Delaware statute also clearly states that the trustee does not have a duty to monitor the conduct of the adviser, provide advice to the adviser, communicate with, or warn any beneficiary or third party regarding directions being implemented on behalf of the adviser. *12 Del. C. § 3313 (e).* The point is that the statute makes it clear that the responsibility is bifurcated. This is very useful when the client has clear intentions where he or she wants the trustee to be directed, and wants a trustee to be able to follow the direction without second guessing the adviser.

Comparison to Other Directed Trust Statutes

If your client is any of the following states, these states do not have directed trust statutes: California; Connecticut; Illinois; Maryland; Massachusetts; New Jersey; and New York (although one has been under consideration in New York in various stages).

If your client is any of the following states, these states and the District of Columbia follow the Uniform Trust Code directed trust statute *UTC § 808(b)*: Michigan, *MCLS § 700.7809(4)*; Virginia, *Va. Code Ann. § 55-548.08(B)*; Washington, D.C, *D.C. Code § 19-1308.08(b)*.

If your client is in Florida or Georgia, those states have an enhanced directed trust statute, similar to Delaware's statute. In Florida, a co-trustee may direct another co-trustee and the directed co-trustee will not be liable for the actions of the directing co-trustee other than a case of willful misconduct by the directing co-trustee and actual knowledge of such misconduct, by the directed co-trustee. The directed co-trustees have no duty to review, inquire investigate, or make recommendations or evaluations with respect to the exercise of the power. *Fla. Stat. § 736.0703(9).* Although this provides a substantial level of protection, it still may not provide the full amount of freedom that the client is seeking. This is because whether the trustee has "actual knowledge" of such misconduct by the party directing the trustee could be a factual matter of question by anyone contesting the actions of the trustee. Also the standard of willful misconduct is on the party directing, not the trustee. Thus, the standard of liability for the trustee is not specified.

In Georgia, the standard of liability for the trustee is bad faith or intentionally or with reckless indifference to the interest of the beneficiary or for liability for any profit which the trustee has derived from a breach of trust. *O.C. G.A. § 53-12-194.* The Georgia statute covers investment decisions only, and does not address being directed to sell. Similar to the Florida statute, the Georgia statute provides a higher level of protection, but not the same level as the Delaware statute.

<u>Relevant Case Law on Directed Trusts</u>

Three cases bear mention. The *Duemler* case is a Delaware case that was completely on point and upheld the Delaware statute. The *Rollins* case is a Virginia case where the outcome was not full protection for the trustee. The *Paradee* case is a Delaware case that refers to the Delaware trust adviser statute and its standard of liability.

In *Duemler*, the trustee provided a prospectus to the adviser for an investment decision on one of the trust's assets. The adviser did not act on the prospectus, and the asset experienced a significant decline in value. The court ruled that the trustee did not act with willful misconduct, and therefore, under § 3313 (b) of Title 12 of the Delaware code, the trustee was not liable for any loss. The court further explained that, if the trustee were liable in such situations for the failure to provide information or to make sure that the investment adviser making the decision knew what they were doing, it would "gut the statute". *Duemler V. Wilmington Trust Company, 20033 NC, 2004, Strine, V.C. (Nov. 24, 2004)*.

In *Rollins,* the trust held a concentrated position in an asset that had a significant decline in value. Under the trust agreement, the beneficiaries had the power to direct the trustee to hold the asset, which they did. The beneficiaries sued the trustee for breach of fiduciary duty, and the court held that the Virginia statute provided that the trustee could follow the directions of the parties directing the trustee, and that the trustee was not liable for a failure to diversify. The court went on to say, however, that the trustee had a common law duty to warn the beneficiaries of the inherent danger in holding the concentrated position, and found the trustee liable for failing to warn the beneficiaries of the impending decline in the concentrated position. *Rollins v. Branch Banking Trust Company of Virginia, 2001 Va. Cir. Lexis 146 (Va. Cir. Ct. 2001)*. As the case was ultimately settled out of court, the actual damages awarded are not known. As noted above, the Delaware statute clearly states that the trustee does not have a duty to warn or review the actions of the adviser. *12 Del. C. § 3313 (e)*.

Lastly, it is noteworthy that in November, 2010 in the *Paradee* case, the Delaware Court of Chancery referred to the standard of willful misconduct under § 3313 of Title 12 of the Delaware code, even though there was not a trust adviser in that case. This shows the Court's continued referral to Delaware's trust adviser statute.

It is the total bifurcation of responsibility between the trust adviser and the trustee, the high standard of liability provided under the Delaware statute, and relevant case law that enables a Delaware trustee to serve the client's needs to have a directed trustee without the trustee looking over the shoulder of the of the adviser giving the directions.

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